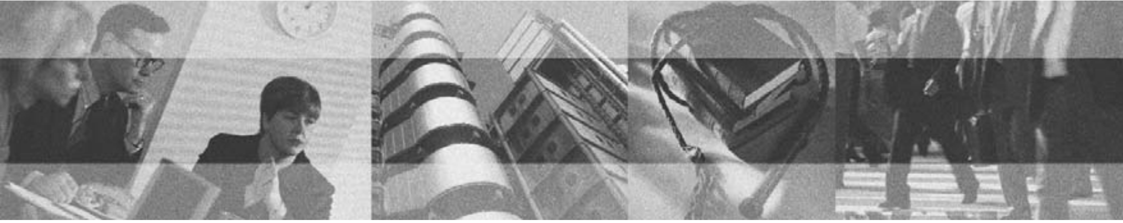


THE LONG ARM OF FSA INSURANCE JURISDICTION

By Jonathan Goodliffe, Freshfields, Bruckhaus, Deringer LLP Lawyers

1 Introduction

In this article I consider the extra-territorial application of certain conduct of business rules of the UK Financial Services Authority (FSA). I argue that that extra-territorial application is:

- inappropriate,
- inconsistent with general UK policy on extra-territorial application of its regulatory system, and
- based on an apparent misconception of the applicable European rules.

2 The European insurance regime

The Financial Services Authority supervises the underwriting and mediation of insurance in the UK. The UK is one of 30 member states of the European Economic Area (EEA), each with its own insurance supervisor. All these supervisors operate within the framework of European legislation. The legislation is contained in the European Treaties and in Directives adopted under the Treaties.

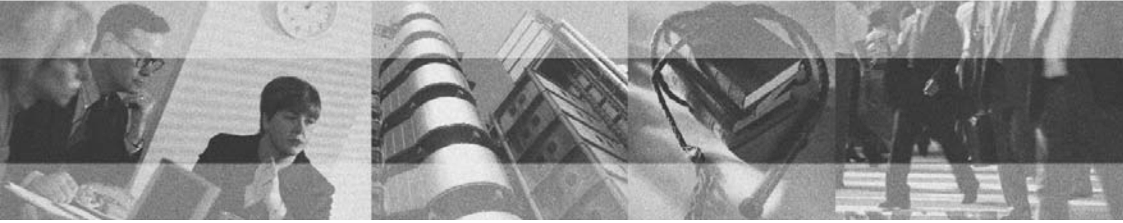
Unlike some other EEA supervisors, the FSA has the power to make legally enforceable rules applying to the firms which it regulates, as well as operating within the requirements of legislation adopted by the UK Parliament. Firms regulated by the FSA include insurance companies and insurance intermediaries.

Each EEA regulator, whether it be the insurance supervisor itself (as in the case of the UK) or a Government Department, must determine the extent to which its rules may apply extra-territorially. The Insurance Directive regime requires member states to apply prudential requirements only to firms whose head office is based in their territory, usually referred to as their "home state".

The Directives contemplate, on the other hand, that member state A may apply conduct of business rules to insurers and intermediaries authorised in member state B who insure general insurance risks or long term insurance commitments which are treated as located in member state A. In the remainder of this article I use the word "risk" as a shorthand for "risk and/or commitment".

The general rule is that where a policyholder who is habitually resident in state A takes out an insurance policy, the risk is treated as located in state A for regulatory and insurance premium tax purposes. There are some exceptions to this rule for, for instance, property and motor insurance, but they are not relevant to the subject matter of this article.

Some EEA member states do indeed as a matter of general policy apply insurance and/or reinsurance regulatory requirements which are triggered by the location of the insurance risk in their territory. So, for instance, an insurer authorised and operating in Bermuda but covering risks located in such an EEA state, "A", might require a full authorisation in state A, even if the insurer had no presence at all in that state.



3 The passporting regime

By contrast an insurer authorised in another EEA member state, "B", would be able to cover risks located in state A (usually referred to as the "host state") after complying with a much less onerous "passporting regime". This merely requires the insurer to obtain the approval of and provide specified information to its home state supervisor who then, if it approves, passes on that information to the host state supervisor. The passporting insurer can, after a short interval, insure risks in state A.

Where the host state is the UK, a passporting insurer from another EEA state acquires an FSA authorisation under the Financial Services and Markets Act 2000 (FSMA). It also acquires FSMA permissions to carry out the insurance business which it is passporting and for other incidental activities regulated under FSMA. Its status as an authorised person then makes it subject (in common with UK regulated firms) to the FSA's wide rule making powers.

4 UK policy on territoriality

So, like other EEA insurance regulators, the FSA has the power to apply regulatory requirements to insurers from other member states who cover risks located in the UK, regardless of the existence of any other connection with the UK.

Subject to a number of exceptions, however, in general the FSA does not apply requirements by reason only that insurance risks are located in the UK. There are a number of reasons for this.

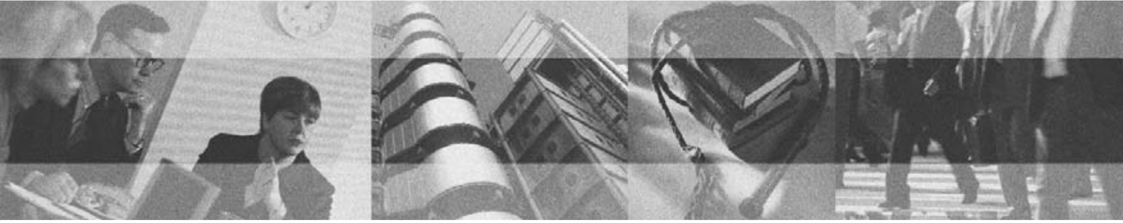
First, the main activity carried out by insurers which is regulated in the UK is the "effecting and carrying out of contracts of insurance". This activity is only regulated in the UK when it is carried out in the UK. The "in the UK" element requires some local presence (see, for instance, *In re Great Western Assurance SA* [1999] Lloyd's Rep I.R 377). An insurer authorised in Bermuda, for instance, can, if it is properly organised, cover UK insurance risks without needing a UK authorisation. Indeed if it could not Bermuda might lose its raison d'être as a major offshore insurance jurisdiction.

Secondly, even though the FSA's rule making power in relation to passporting EEA insurers is not dependent on their carrying on a regulated activity in the UK, the FSA's conduct of business rules are usually only applied to a:

> "firm with respect to … activities carried on from an establishment maintained by it, or its appointed representative, in the United Kingdom."

See Rule 1.1.1R of the FSA's Conduct of Business Sourcebook (COBS) and Rule 1.1.1R of its Insurance Conduct of Business Sourcebook (ICOB). This is in line with the UK's generally conservative approach to the exercise of extra-territorial jurisdiction in financial regulation.

The meaning of "establishment" is described in detail in an Interpretative Communication published by the European Commission (2000/C 43/03). It denotes a permanent presence. Although sometimes it may be difficult for a foreign insurer or intermediary to sell its products in the UK without an establishment in that state, this will not necessarily always be the case, particularly when products are sold over the Internet.



The only aspect of the FSA regime which is invariably applied at least to some extent on an extra-territorial basis is its financial promotion (i.e. advertising) regime. The financial promotion rules apply to the extent that a "communication is capable of having an effect in the United Kingdom" (section 21(3) FSMA).

Subject, however to the requirement that advertising aimed at the UK should be "fair, clear and not misleading" (COBS 4.2.1R(1) and ICOBS 2.2.2R) these rules are perhaps the least onerous part of the FSA rulebook in compliance terms. They cannot apply, in any event, to advertisements in an EEA jurisdiction other than the UK which are, for instance, seen by a UK national only because he is temporarily outside the UK.

5 Non-investment insurance, investment insurance, general insurance and life or long term insurance

At this point it is necessary to digress briefly for the benefit of the uninitiated.

A reasonable person might expect any FSA conduct of business rules relating to insurance to be contained in its Insurance Conduct of Business Sourcebook (why otherwise, after all, have an Insurance Conduct of Business Sourcebook?). In fact, however, ICOBS only contains rules relating to non-investment insurance. The conduct of insurance business where the insurance has an investment value is regulated by COBS, along with a number of other non-insurance investment type financial products.

Non-investment insurance includes all general insurance such as motor and household insurance. General insurance is usually renewed annually. Non-investment insurance also includes life or long term insurance which does not acquire an investment or surrender value. Examples are whole of life or term assurance, and mortgage protection insurance. These are usually referred to as "protection insurance".

"Investment insurance" regulated under COBS includes, for instance, single premium bonds, mortgage endowment policies and personal pension policies.

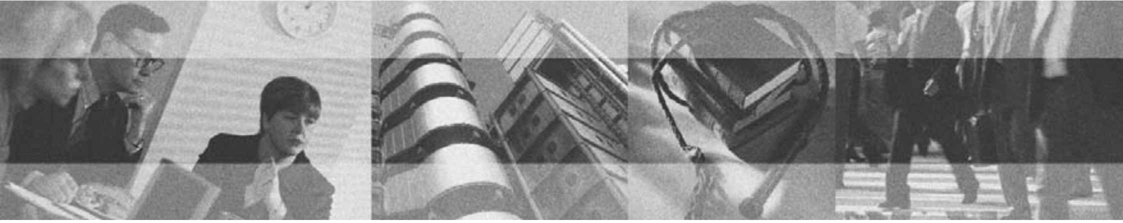
Non-investment insurance is regulated under ICOBS whether it be general insurance or protection insurance. There are, however, distinct European Directive regimes applying to, on the one hand, general insurance and, on the other, life or long term insurance (whether in the nature of protection insurance or investment insurance).

6 Extra territorial application of FSA rules to long term insurance

A number of provisions in the Life Assurance Directive (2002/83/EC) seem to be relied upon by the FSA as requiring it to apply certain parts of its rulebook extra-territorially, notwithstanding its usual conservative approach described above. These rulebook provisions relate to the sale of long term insurance products. In this article I will focus on rules relating to investment insurance within COBS. The same analysis, however, applies to equivalent rules relating to protection products in ICOBS.

Paragraph 5 of COBS 1 Annex 1 Part 3 says:

"5.1.G The Consolidated Life Directive's scope covers long-term insurers authorised under that Directive conducting long-term insurance business. The rules in this



sourcebook within the Directive's scope are the cancellation rules (COBS 15) and those rules requiring the provision of pre-contract information or information during the term of the contract concerning the insurer or the contract of insurance. The Directive specifies minimum information and cancellation requirements and permits EEA States to adopt additional information requirements that are necessary for a proper understanding by the policyholder of the essential elements of the commitment.

5.2 G If the State of the commitment is an EEA State, the Directive provides that the applicable information rules and cancellation rules shall be determined by that state. Accordingly, if the State of the commitment is the United Kingdom, the relevant rules in this sourcebook apply. Those rules do not apply if the State of the commitment is another EEA State. The territorial scope of other rules, in particular the financial promotion rules, is not affected since the Directive explicitly permits EEA States to apply rules, including advertising rules, in the 'general good'. (See articles 33, 35, 36 and 47 of the Consolidated Life Directive)."

Case studies

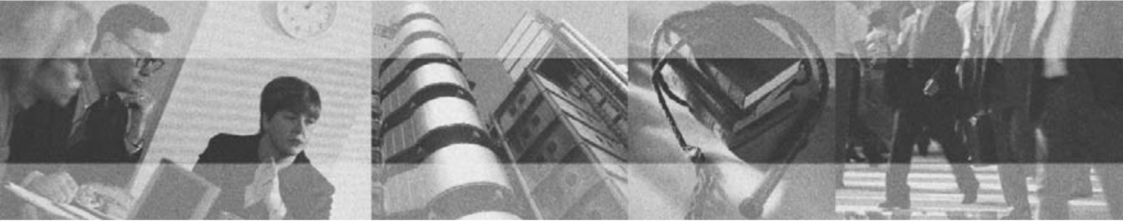
So, for instance, a Swedish insurer selling long term insurance products to people temporarily in England (on, say, a six month job secondment), but who have retained their Swedish habitual residence, do not need to comply with the FSA's cancellation and information rules. They comply with the Swedish rules.

By contrast it would seem that a US insurer selling similar products to US ex-patriates from a UK establishment must comply with UK rules since COBS Annex 1 Part 1 only disapplies the territoriality rules when the state of the commitment is another EEA member state. If the insurer does not operate through a UK establishment, is not carrying on its insurance business in the UK, but for instance selling over the Internet, the UK rules will not apply. The rules of the relevant US state may, of course apply.

Take the case, on the other hand, of a UK national who spends most of the year in London, but also spends significant periods at his château in the South of France, so he retains a UK habitual residence. A French insurance company operating in, say, Bordeaux, cannot sell him, for instance, a single premium insurance bond without passporting into the UK. It may, of course, already have done. It must also comply with the extensive and onerous requirements applied under COBS 1 Annexe 1. In fact it may need to ensure that it is in a position to comply with a large range of different national requirements depending on the habitual residence (which could be Estonia, for instance) of whoever may be interested in buying its products.

Suppose, on the other hand, that the partly expatriate UK national is an avid skiier rather than a wine connoisseur. He has a chalet in Verbier, Switzerland, where he spends a significant amount, although not the majority, of the year, so he too has a UK habitual residence. On an expedition to the nearest large town, Lausanne, he is sold a similar single premium insurance bond by a Swiss insurance company.

The FSA's Conduct of Business rules do then apply unless the Swiss insurance company has a full UK authorisation (which is unlikely). This is because the insurance company is not carrying on a regulated activity in the UK by covering the insurance product and selling it to the UK



skier. It cannot passport into the UK and become subject to the FSA's rules since Switzerland is not an EEA state.

It would appear (not being a Swiss lawyer I cannot be sure: there may be special Swiss conflict of law rules which come into play) that the notification requirements under the Swiss Federal Insurance Contract Law will apply. One would expect an equivalent result to arise in other non EEA jurisdictions, e.g. the Channel Islands, the USA, and Australia.

So the Swiss insurance company only complies with one system of rules – its own. That seems a more sensible and less onerous result for the insurance company than applies within the EEA. In a sense this is perverse, since one of the points of the EEA is to create conditions which are favourable to the development of the internal market, rather than conditions which are significantly less favourable than those which apply outside the market. Moreover would any UK ex-pat expect FSA rules to apply when he is shopping for insurance products abroad, except, perhaps, when he is buying them from a UK insurance company?

8 Is the FSA legal analysis right?

Paragraph 5 of COBS 1 Annex 1 Part 3, quoted above suggests that the FSA is applying its rules extra-territorially not as a matter of policy, but because it considers that it is required to do so by the terms of the Life Assurance Directive. I suggest that that view of the Directive is mistaken.

Article 36 of the Directive sets out in annexe III(B) the minimum notification requirements to be given to policyholders under long term insurance contracts. It provides in paragraph 3 that:

> "The Member State of the commitment may require assurance undertakings to furnish information in addition to that listed in Annex III only if it is necessary for a proper understanding by the policy holder of the essential elements of the commitment."

In fact most member states, including the UK, have added to the minimum notification requirements.

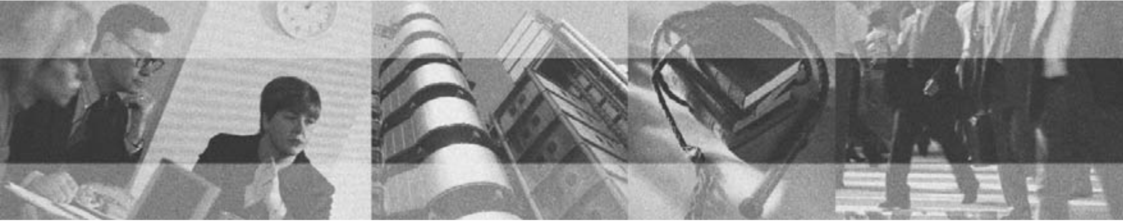
Paragraph 4 then provides:

> "The detailed rules for implementing this Article and Annex III shall be laid down by the Member State of the commitment."

The FSA appears to take the view that this requires it to apply its rules in all sales where the member state of the commitment is the UK. This is not what the Directive says. It is not a UK statute and should not be construed as such. The Directive merely requires that the rules shall be "laid down". They should then apply in most cases.

It is not necessary, to achieve the Directive purpose, that they should apply in all cases. Article 32 allows the parties to an insurance contract to choose to apply a law other than the law of the commitment. Why then should the member state regulator not also be in a position to choose in specific cases to modify the application of its rules, provided that they achieve the Directive purpose?

The directive purpose includes advancing the right of establishment and the freedom to provide services. This is hardly served by requiring member states to apply their rules extra-territorially when to do so imposes a regulatory burden with no obviously corresponding benefit.



How, then, should the rules apply?

I believe there is a practical solution to the application of FSA rules to overseas sales to UK residents. It is not just a question of completely disapplying FSA rules to transactions which take place abroad. This is because if, for instance, the FSA rules were simply disapplied in relation to transactions entered into by UK habitual residents when they are abroad, the local requirements might not apply either, because those requirements might only apply to local risks. It is desirable that at one set of rules (and no more) should apply for the protection of consumers

I suggest, therefore, that firms should be given the option of complying with COBS in relation to such transactions where the commitment is located in the UK. They should also have the option of complying with equivalent national requirements which would apply if the risk under the insurance policy was properly to be treated as a risk of the state where the sale actually takes place. A similar approach might also perhaps be applied in the case (identified above) of non EEA ex-pats being sold long term policies through UK establishments of non EEA insurers.

There is at least one precedent for such an approach to rule making. In the original version of the FSA's Insurance Conduct of Business Sourcebook (called ICOB to distinguish it from the current ICOBS), certain rules were only applied extra-territorially where they were carried on in a member state which had not implemented the Distance Marketing Directive (2002/65/EC). See in this regard the original ICOB Rule 1.3.2AR.

Applying for a waiver

It would in any event be open to any insurance company to apply for a modification (usually referred to as a "waiver") of FSA rules under section 148 FSMA to achieve the result I have suggested. Such a modification would only apply to the company in question, although it might create a precedent for other firms to make a similar application.

In the event of a waiver application, the FSA might or might not depart from its original legal analysis – if indeed I have understood it correctly. When it was consulting on its ICOBS rules I wrote to the FSA suggesting that the territorial application of the long term insurance rules was excessive. I also drew its attention to other rules where the territorial application was arguably too conservative. It did not enter into correspondence or discuss the issue.

If the FSA were not to change its legal view, its refusal to grant a section 148 modification might be challenged by way of judicial review. The challenge might need to be referred to the Court of Justice of the European Communities. This would be an unwieldy process likely to take 2 years or more. Few if any firms would be willing to launch such a challenge, even with the most optimistic advice from their lawyers. The legal costs would be significant and there is a notable reluctance on the part of many firms even to enter into dialogue with the regulator on issues such as these.

In any event since (if my analysis is correct) it is possible to compose an amendment which defines in advance how the rules should and should not apply, it seems more appropriate that the rules should be changed than that firms should be left to apply for waivers.