



THE FINANCIAL SERVICES AUTHORITY

AN INTRODUCTION FOR INSURANCE INTERMEDIARIES

By Michael Kent QC



His practice is in professional negligence, building contracts, property disputes involving developers, product liability (contaminated blood products, the Camelford water pollution cases, CJD from human growth hormone) and other group litigation.

References are to the Financial Services and Markets Act 2000, which has 433 sections and 22 schedules.

The Regulatory Structure

1. **Terminology:** *Authorised Persons, Appointed Representatives and Approved Persons*. This is nomenclature calculated to confuse.
2. **Authorised persons:** those who carry on, by way of business, any activity of a specified kind which relates to a specified investment: S 22. That is a “**regulated activity**”. Such persons need permission under Part IV of the Act. Note they will need a permission wide enough to cover any regulated activity they may, how ever occasionally or peripherally, want to engage in: they are not allowed simply to assume the status of appointed representative or approved person for the occasion.

3. Under Sch 2 “investments” includes “rights under contracts of insurance” (para 20) and “participation in a Lloyd’s syndicate” (para 21). Specified activity includes (under the FSMA 2000 Regulated Activities Order 2001 (“RAO”) “effecting and carrying out contracts of insurance as principal” (reg 10). Part IV authorisation is deemed for insurance companies having an existing authorisation under sections 3 or 4 of the Insurance Companies Act 1982. The Society of Lloyd’s and its Council continue to regulate that market but now under the general oversight of the FSA (Part XIX of the 2000 Act).
4. But the reach of the Act now goes much further than insurers and the amended RAO now covers insurance brokers and others in the supply chain. Art 21 RAO as amended: “Dealing in investments as an agent”; Art 25: “Arranging deals in investments”. “Relevant investments” is a new phrase in the RAO defined to include “rights under a qualifying contract of insurance and rights under any other contract of insurance”. (Art 3 (1). These changes take effect from 14 January this year (14 October last year in relation to long-term care insurance).
5. Lloyd’s underwriting agents are given deemed Part IV permission under the transitional arrangements. Others will have had to make their applications for authorisation by 13th January (they are required to be determined within 6 months) and transitional provisions allow you to continue transacting business as before pending determination. But, in that transitional period, the broker or other intermediary will be operating under the rules put in place by and under the 2000 Act. There are complicated provisions conferring exemption or deemed authorisation on EEA and other overseas intermediaries.
6. An Authorised Person, cannot also be an Appointed representative or Approved Person. This is true even in relation to a regulated activity different from that for which authorisation was obtained—in that case the authorisation must be extended.
7. **Appointed Representatives:** s 39 of the Act defines and exempts such persons from the general prohibition, i.e. they do not have to become Authorised Persons (though they may be required to be Approved Persons: see below). They are persons who have entered into a contractual arrangement with an Authorised person which permits them to carry on business of a prescribed description (i.e. prescribed in the RAO). The essential requirement is that the Authorised Person has accepted responsibility in writing for the representative’s activities and is, under the statute, “responsible, to the same extent as if he had expressly permitted it, for anything done or omitted by the representative in carrying on the business for which he has accepted responsibility.”

8. The Insurance Mediation Directive (Misc Amendments) Regs. 2003 the RAO is extended also to cover “appointed representatives” who carry out an “*insurance mediation*” activity. A record of these persons must be kept by the FSA and they may be excluded from the record if they appear to the FSA not to be fit and proper persons to carry on insurance mediation activities. “Insurance mediation” is the jargon of the Insurance Mediation Directive 2002/92/EC. They cover: “*The activities of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration of such contracts, in particular in the event of a claim*” other than such activities carried out by an insurance undertaking itself (or its employee) ¹.
9. An Appointed Representative may also need to be an Approved Person.
10. **Approved persons:** Approval for such persons is required under Part V Performance of Regulated Activities. S 59 requires an authorised person to take reasonable care to ensure that no person performs a “controlled function” without FSA approval.
11. These are individuals who carry on a “**controlled function**”². It means both the frontline troops and the general staff but not those in the middle or carrying out back office work only. At one end are those exercising a significant influence on the conduct of the affairs of an authorised person (i.e. firm) thus senior management. At the other (sharp) end are those who deal with customers or their property in a way “substantially connected with the regulated activity”. Applications for approval must be made by or on behalf of all such persons (section 61: they should be determined within three months). Such persons are entitled to approval if the FSA is satisfied they are “fit and proper”. Regard must be had to any qualifications, training and level of competence relevant to the functions to which the application relates. *Hoodless and Blackwell v FSA* [2004] JIBLR 146 gives some guidance on the application of this test.

The Rules.

12. Some appear in the Act itself, others are made by FSA or the Secretary of State under delegated powers.

¹ Certain insurance mediation services are excluded: essentially breakdown warranties or similar failure cover ancillary to a product or service for an annual premium of not more than 500 Euros and five year total duration including renewals.

² i.e. specified by FSA in Rules.

13. **Terminology:** Rules, Statements of Principle and Codes, Guidance. They are found in the **Handbook and Rules of Guidance**, which contains Sourcebooks and Manuals. Examples are: *Statements of Principle and Codes of Practice for Approved Persons*; *The Fit and Proper Test for approved persons* (both “High level standards”); *Interim Prudential sourcebook for insurers*; *Insurance: conduct of business* (both “Business standards”).
14. **Rules.** FSA has rule-making powers under s 138 and ss 140-7. These are directed at authorised persons and are denoted in the Handbook by the letter **R**.
15. **Directions** (denoted by **D**) are binding on persons to whom they are directed (usually such mundane things as prescribing forms for applications etc.). These are unlikely to be important.
16. **Statements of Principle (P)** are supplemented by codes of practice applying to approved persons.
17. **Evidential provisions (E)** which (see s 149) create rebuttable presumptions arising out of either compliance or contravention.
18. [You will also see letter **C** which refers to paragraphs made under s 119 relating to market abuse where the circumstances are conclusive in favour of an approved person].
19. **Guidance (G)**. This, the most benign of all, imposes no obligation and failure to follow it can have no adverse consequences. But following guidance is a good idea as FSA have said that those who do “*will usually have a ‘safe harbour’ from disciplinary action*”.

Consequences of non-compliance

Enforcement

The possibilities:-

- a) Criminal penalties.
- b) Prohibition orders (re performance of controlled functions: affects otherwise exempt appointed representatives);
- c) Refusal/withdrawal/variation of permission (authorised persons regime);

- d) Refusal/withdrawal of approval for carrying out controlled functions (approved persons regime);
 - e) Private warnings;
 - f) Disciplinary action (fines, public censure);
 - g) unenforceability of contracts and/or restitution;
 - h) Liability to pay damages for breach of statutory duty;
 - i) Asset freezing injunctions;
 - j) Restitution orders.
20. There is an **Enforcement handbook** setting out the FSA's policy (including types and severity of sanctions).
21. **Contravention of the general prohibition** (i.e. performing regulated activities without permission -- actual or deemed-- or exemption). This is a criminal offence under the Act (up to two years in prison: section 23) subject to a defence that all due precautions were taken and exercised all due diligence to avoid committing the offence.
22. Agreements made in such circumstances are unenforceable and any property or money transferred is recoverable.
23. Note that an Authorised person who carries on a regulated activity which goes beyond the scope of his permission is not contravening the general prohibition.
24. **Prohibition orders:** if it appears to FSA that an individual is not a fit and proper person to perform functions in relation to a regulated activity it may make a prohibition order prohibiting him/her from performing any specified function (section 56).
25. **Authorised persons** carrying on a regulated activity otherwise than in accordance with their permission commits no offence and contracts made are not rendered unenforceable. But (in addition to possible disciplinary action) there is potential for an action for damages at the suit of a "private person" (section 20 (3):

Reg. 3(1) ... "private person" means-

(a) any individual, unless he suffers the loss in question in the course of carrying on—

(i) any regulated activity; ...

(b) any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind; but does not include a government, a local authority (in the United Kingdom or elsewhere) or an international organisation.

(2) for the purpose of paragraph (1) (a), an individual who suffers loss in the course of effecting or carrying out contracts of insurance ...written at Lloyd's is not to be taken to suffer loss in the course of carrying out a regulated activity.

26. But agreements made by an authorised person "in consequence of something said or done" by an unauthorised person who acts in contravention of the general prohibition are unenforceable and property and money returnable (section 27).
27. Authorised persons are also at risk of an action for damages at the suit of a "private person" under section 71 for failing to take reasonable care to ensure that a person subject to a prohibition order under section 56 (see below) does not carry out prohibited functions and that controlled functions are only performed by approved persons.
28. **Contravention of a Rule by authorised persons:** there is no criminal offence committed and agreements are not unenforceable (see section 151) but there is a potential action for damages by a "private person" (section 150).
29. **Disciplinary action against authorised person:** see sections 205 (public censure) and 206 (unlimited fine) for contravening a "requirement imposed by or under this Act". The scope of this phrase is not entirely clear. It undoubtedly includes express requirements in the Act itself and in Rules other than Rules stated (under section 149) to be "evidential only". It must also extend to requirements of delegated legislation made under the Act e.g. the Money Laundering Regs 2003 (made under s 146) and the regs made under ss 342-3 ("whistle blowing" by auditors) but not regs concerning similar subject matter but made under a different parent Act.
30. It is unclear if it covers a requirement made at one remove e.g. imposed by auditors who are empowered by rules made under s 340 to require authorised persons to act in a particular way.
31. **Approved persons:** They may suffer withdrawal of approval as not being "fit and proper" (section 63) and are subject to disciplinary proceedings under section 66 (with a two year time limit) resulting in public censure and/or an unlimited fine for failure to comply with a Statement of Principle applicable to them (under section 64) or being knowingly concerned in a contravention by an authorised person.

Investigation and assistance by the courts

32. Under part XI there are extensive powers of investigation including requiring authorised persons to provide information and produce documents (section 168). A “competent person” may be appointed investigator who may summon persons being investigated or “connected persons” (sections 171,2). Answers and admissions are admissible in proceedings save criminal proceedings (section 174). Lawyers may be required to reveal the names and addressees of their clients (section 174) but otherwise legal professional privilege is honoured (section 413). Justices warrants may be obtained (section 176) and there are criminal penalties for non-compliance (section 177).

Role of the Courts and the Tribunal

33. **Courts:** The FSA may apply to the High Court under section 380 for a freezing order and under section 382 for a restitution order.

34. Judicial review, e.g. of policy or rule making by FSA or sec of State: are they consonant with the regulatory objectives and proportionality principle. Relevant are the following:

Section 2 (1): *In discharging its general functions the Authority must, so far as is reasonably possible, act in a way*

- (a) *which is compatible with the regulatory objectives;*
- (b) *which the Authority considers most appropriate for the purpose of meeting those objectives.*

(2) *The regulatory objectives are—*

- (a) *Market confidence;*
- (b) *Public awareness;*
- (c) *the protection of consumers; and*
- (d) *the reduction of financial crime.*

Section 5 (1): *The protection of consumers objective is: securing the appropriate degree of protection for consumers.*

(2) *In considering what degree of protection may be appropriate, the Authority must have regard to—*

- (a) the differing degrees of risk involved in different kinds of investment or other transaction;*
- (b) the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;*
- (c) the needs that consumers may have for advice and accurate information;*
- (d) and the general principle that consumers should take responsibility for their decisions.*

Rules made under section 138 are such as are “*necessary or expedient for the purpose of protecting the interests of consumers*”. “*Consumers*” are defined widely to cover

“*persons--*

(a) who use, have used, or are or may be contemplating using any of the services provided by—

- (i) authorised persons in carrying on regulated activities; or*
- (ii) persons acting as appointed representatives*

(b) who have rights or interests which are derived from, or are otherwise attributable to, the use of any such services by other persons; or

(c) who have rights or interests which may be adversely affected by the use of any such services by persons acting on their behalf or in a fiduciary capacity in relation to them.”
(section 138 (7)).

Section 2 (3): *In discharging its general functions the Authority must have regard to—*
...(c) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;

35. **The Financial Services and Markets Tribunal:** determines referred of FSA decisions, e.g. under section 55 (refusal, cancellation or variation of Part IV permission), sections 57 and 58 (prohibition notices), sections 62 and 63 (refusal or withdrawal of approval under section 59), section 66 (disciplinary action against approved persons) and section 206 (disciplinary action against authorised persons).

36. The procedure is for the FSA first to give a warning notice of their intended adverse action or decision. That gives the person or persons affected the opportunity to make representations. If they are unsuccessful the FSA then give each affected person a decision notice.. At that point (and not before)

there arises a right to refer to the Tribunal. But note that there is no power in the Act to suspend the decision or suppress publication pending the outcome of the reference to the Tribunal. Attempts by way of judicial review to restrain the FSA from proceeding to that point have not been successful (see *R (Davies) v FSA* [2003] EWCA Civ 1128).

37. The Tribunal is completely independent of FSA both in theory and in practice. In *Hoodless and Blackwell v FSA* [2004] JIBLR 146 the FSMA Tribunal considered the “fit and proper test” in relation to allegations of dishonesty. They adopted a combined objective and subjective test: “did his actions fall below the standards of ordinary decent people? If so did he himself realise that what he was doing was dishonest by those standards?”. Here was an example of the Tribunal not allowing the “consumer protection” aspect to dominate (in which case a purely objective test might have been thought to be necessary for consumer protection).
38. Decisions of FSA referred to the Tribunal are decided de novo (section 133); there is not just a review of the reasonableness or lawfulness of FSA action. But it is necessary to bear in mind what is being decided by reference to the particular statutory provision underlying the decision demonstrated in *Thomas v FSA* supra. There the FSA had refused the Applicant approval to perform controlled functions on the ground that it was not “satisfied that [he] was a fit and proper person to perform the functions to which the application relates” (section 61 (1)). As an investigation was continuing into the applicant under Part XI of the Act FSA did not want to commit pre-empt its outcome by committing themselves to an assertion that he was not in fact fit and proper but they wanted to “take him off the road” in the meantime. The Tribunal held that its task on referral of that decision was to decide, not whether he was in fact fit and proper, but whether the FSA could prove on the balance of probabilities that the Tribunal could not be satisfied that he was (a subtle but real difference).
39. The Tribunal’s powers extend to refusing to allow the FSA to pursue its proposed action (e.g. a prohibition notice under section 56) on such “judicial review” grounds as irrationality and unfairness (including abuse of process): see *R (Davies) v FSA* (supra).
40. There is an appeal to the Court of Appeal on points of law only, with permission of the tribunal or the CA: section 137.

41. **Human Rights Act considerations:** In *FSA v Matthews* [2004] EWHC 2966 Ch Peter Smith J allowed the Defendant to reopen issues decided adversely by the ombudsman³ which was the basis for an application to the court under section 382 for restitution when their Article 6 rights were infringed by the ombudsman's procedures. No doubt other conventions rights such as those under Article 1 First protocol will feature in developing case law before the courts and the Tribunal.
42. In *Thomas v FSA* (FSMA Tribunal decision released 22 September 2004) it was held that the refusal of approval under section 60 required determination of a civil right so that Article 6 of the European Convention was engaged. It was also argued that the approved persons regime was discriminatory (infringing Article 14) because a different test applied to the withdrawal of an existing approval (applicable where the approved person remains in the same job) and one moving to a new job who must seek a fresh approval. The former can only have his approval removed if he is in fact "not fit and proper". The latter can be refused approval if the FSA are "satisfied" that he is not fit and proper. The Tribunal held that that difference of treatment did not involve unequal treatment of other convention rights as the only relevant right was the right to a fair and public hearing under Article 6 as to which there was no difference of treatment.

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³ There is now, under Part XVI of the Act, one ombudsman regime for complaints by customers against authorised persons whatever the regulated activity.