

**EXPLANATORY MEMORANDUM TO
THE FINANCIAL SERVICES AND MARKETS ACT 2000 (EXEMPTION)
(AMENDMENT NO. 2) ORDER 2007**

2007 No. 1821

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This Order amends the Financial Services and Markets Act 2000 (Exemption) Order 2001 (SI 2001/1201) ("the Exemption Order"), which provides for certain persons to be exempt from the general prohibition imposed by section 19 of the Financial Services and Markets Act 2000 (c.8).

Freight forwarders and storage firms

2.2 Article 2 of the Order adds freight forwarders and storage firms to Part IV of the Schedule to the Exemption Order and exempts those persons from requiring authorisation in respect of activities specified by articles 21, 25, 39A and 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("the RAO") which it carries on in order to provide the service specified in the Order.

Policyholder advocates

2.3 Article 2 of the Order adds a person who is approved or nominated by the Financial Services Authority ("FSA") to act as a policyholder advocate to Part IV of the Schedule to the Exemption Order and exempts that person from requiring authorisation in respect of activities specified by articles 25 and 53 of the RAO. The FSA rules in relation to policyholder advocates, made under section 138 of the Act, can be found in the part of the FSA handbook entitled "conduct of business".

Invest Northern Ireland

2.4 Article 2(2) of the Order provides that Invest Northern Ireland is exempt in relation to the regulated activities listed in article 5(1) of the Exemption Order (most of which relate to investment services).

3. Matters of Special Interest to the Joint Committee on Statutory Instruments

5.1 None

4. Legislative Background

4.1 Section 19 of the Financial Services and Markets Act 2000 (FSMA) provides 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 known in the Act as the general prohibition. Section 22 of

FSMA provides that an activity is a regulated activity if it is an activity of a specified kind: (a) which relates to a specified investment (or, in relation to certain activities, to property of any kind); and (b) which is carried on by way of business. For these purposes “specified” means specified in the RAO.

- 4.2 The Exemption Order provides, subject to any limitation expressed, for persons listed in Part IV of the Schedule to be exempt from the general prohibition in respect of any regulated activity of the kind referred to in relation to him.

Freight forwarders and storage firms

- 4.3 In passing on to a customer rights under a policy of insurance held by a freight forwarder / storage firm in respect of loss or damage to goods it transports / stores, the freight forwarder / storage firm is carrying on one or more of the following regulated activities:
- Article 21 (dealing in investments as agent);
 - Article 25 (arranging deals in investments);
 - Article 39A (assisting in the administration and performance of a contract of insurance);
 - Article 53 (advising on investments).

- 4.4 A freight forwarder / storage firm would therefore currently need to be authorised by the FSA to provide this service to customers. This Order will exempt freight forwarders and storage firms from requiring authorisation where the service is being provided to a customer that is not an individual.

Policyholder advocates

- 4.5 “Rights under a Contract of Insurance” is a specified investment (article 75 of the RAO), and a policyholder advocate is likely to be carrying on two specified activities: arranging deals in investments (article 25 of the RAO); and advising on investments (article 53 of the RAO).

- 4.6 There are two principal elements to the “by way of business” test in this type of case, namely whether or not the person is paid for the regulated activity and whether he is taking up or pursuing the regulated activity by way of business for the purposes of section 22. Both these elements must be satisfied for the FSA to consider that the regulated activities carried on satisfy the “by way of business” test.

- 4.7 A policyholder advocate will almost certainly be paid to carry out the role, and so gain commercial benefit from it. It is also likely that he will be carrying out the role on an ongoing basis over a not insignificant period of time (perhaps as much as a year to 18 months) and on a relatively large scale. Therefore, it is arguable that he will meet the “by way of business” test.

- 4.8 As a result, the policyholder advocate either needs authorisation by the FSA or the benefit of an exemption to carry out the role without authorisation.

- 4.9 This Order provides for exemption from financial services regulation for the policyholder advocate by amending the Schedule to the Exemption Order.

Invest Northern Ireland

4.10 Article 2(2) of the Order makes Invest Northern Ireland exempt from FSMA regulation in relation to the activities listed in article 5(1) of the Exemption Order. These activities are dealing in investments as a principal or agent, arranging deals in investments, managing investments, assisting in the administration and performance of a contract of insurance, safeguarding and administering investments, sending dematerialised instructions, establishing a collective investment scheme or stakeholder pension scheme and advising on investments.

4.11 Article 2(3) makes a clarifying change in the amendment made to the exemption in paragraph 40 of the Schedule to the Exemption Order (enterprise schemes) by the Financial Services and Markets Act 2000 (Exemption) (Amendment) Order 2007 (S.I. 2007/125) to secure that paragraph 40 is compatible with the markets in financial instruments directive (Directive 2004/39/EC).

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

7 Policy background

Freight forwarders and storage firms

7.1 Freight forwarders manage and organise the transport of the customer's goods and insurance is provided as an optional element of the service. The freight forwarder typically does this through the use of a "master cover" policy. The forwarder purchases this policy directly from an insurance company or through an insurance broker. The freight forwarder holds the master policy in its own name. However, if the customer decides to take up the insurance option, the rights of the policy are passed to the customer so that in the event of loss, or damage to, the customer's goods, the customer can make a claim directly against the insurance policy.

7.2 Currently, this passing on of insurance rights under a master cover policy to the customer by the freight forwarder is a regulated activity. Following dialogue with the freight forwarding industry and the European Commission, the Government believes that the specific insurance activities of freight forwarders do not require regulation in order to comply with the Insurance Mediation Directive. The Government also believes that the potential for consumer detriment in this area is low, and that the cost of regulation borne by the UK's freight forwarding industry has a significant impact on the international competitiveness of the sector.

7.3 This instrument will exempt from the scope of FSA regulation such insurance activities by freight forwarders. It will also exempt similar insurance activities

of storage firms as similar arguments apply. The exemption is only applicable where the freight forwarder or storage firm passes on rights under an insurance policy directly to the customer in respect of loss or damage to the customer's goods and where that customer is not an individual.

Policyholder advocates

- 7.4 A reattribution takes place when with-profits policyholders are offered a payment in return for their agreement that they forego future claims on any future excess assets. This can happen when a life insurance company (the "insurer") wants to restructure its with-profits fund. An insurer might decide to opt for a reattribution if, for example, it decided to merge several different with-profits funds into one fund in order to reduce management costs.
- 7.5 However, there have been concerns that there wasn't a representative to act on behalf of the policyholders' interests and negotiate with the insurer. Policyholders were perceived as not getting the best deal. As a result, the Financial Services Authority (FSA) introduced rules that created such a role – the policyholder advocate. The policyholder advocate is an independent figure representing policyholders' interests to the insurer (and where required, to the FSA and others). Broadly, the policyholder advocate's function will be to negotiate with the insurer on behalf of policyholders in relation to the value of benefits the insurer is offering to them. He will then give the policyholders advice on whether the insurer's proposals are in their interest.
- 7.6 Advising on and arranging deals in rights under contracts of insurance are regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO") and a person carrying on such activities is therefore required either to be authorised by the FSA or exempt from authorisation. In order to carry out his role, it is likely that the policyholder advocate will be carrying out regulated activities.
- 7.7 This Order amends Part IV of the Schedule to the Exemption to enable a policyholder advocate to carry out the functions intended in the FSA rules without being authorised by the FSA. In particular, the proposed amendments would exempt a policyholder advocate from requiring authorisation in respect of the regulated activities specified by articles 25 and 53 of the RAO, which relate to arranging deals in, and advising on, investments.

Invest Northern Ireland

- 7.8 Invest Northern Ireland is the economic development agency for Northern Ireland. Its role is to support the development of businesses in Northern Ireland and attract foreign investment. It provides a range of services for example: arranging trade missions and business advice in relation to energy efficiency and e-business.
- 7.9 Exemption from FSMA provides that the entity can undertake certain financial services activities without complying with FSMA and FSA regulation. An exemption would be beneficial for Invest NI because financial services are a very small part of their role and the costs of regulation would be disproportionate.

7.10 Invest Northern Ireland has been consulted about the proposed exemption, and is content with it. The Treasury are satisfied that granting the exemption is consistent with the United Kingdom's Community obligations, in particular under the markets in financial instruments directive..

8. Impact

8.1 Two full Regulatory Impact Assessments (RIA) have been prepared for this instrument – one relating to the freight forwarder measure and one to the policyholder advocate measure. The RIAs accompany the draft Statutory Instrument. No RIA has been prepared for the exemption for Invest Northern Ireland because no impact on the private or voluntary sectors is foreseen.

9. Contact

9.1 Richard Wronka at HM Treasury, tel: 020 7270 5389 or e-mail: richard.wronka@hm-treasury.gov.uk can answer any queries regarding aspects of the instrument relating to freight forwarders and storage firms.

9.2 Sarah Kirby at HM Treasury, tel: 020 7270 5173 or e-mail: sarah.kirby@hm-treasury.gov.uk can answer any queries regarding aspects of the instrument relating to policyholder advocates.

9.3 John Sparrow at HM Treasury, tel: 020 7270 5312 or e-mail: john.sparrow@hm-treasury.gov.uk can answer any queries regarding aspects of the instrument relating to Invest Northern Ireland.

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FINAL REGULATORY IMPACT ASSESSMENT

TITLE OF PROPOSAL

1.1 Removing freight forwarders' and storage firms' insurance activities from the scope of Financial Services Authority (FSA) regulation.

PURPOSE AND INTENDED EFFECT

Background, objective and rationale

1.2 Since the introduction of FSA regulation of the selling of general insurance in the UK on 14 January 2005, which followed extensive consultation by HM Treasury and the FSA, the Government has considered it necessary for the FSA to regulate freight forwarders' insurance activities in order to comply with the requirements of the Insurance Mediation Directive (IMD)¹. Following discussions with the UK's freight forwarding industry – initiated by concerns from the industry that other EU Member States are not regulating freight forwarders' insurance activities - HM Treasury has approached the European Commission to discuss whether the insurance activities of freight forwarders should be subject to regulation. Following this dialogue, the Government now believes that it will be possible to comply with the requirements of the IMD without requiring the regulation of freight forwarders' insurance activities. The Government also believes that the potential for consumer detriment in this area is low, and that the cost of regulation borne by the UK's freight forwarding industry has a significant impact on the international competitiveness of the sector.

1.3 Given these considerations, the Government believes that it is appropriate to remove freight forwarders' insurance activities from the scope of FSA regulation. However, FSA regulation will still apply to the selling of the original insurance policy to the freight forwarder² and, where insurance rights are then passed on to the customer, the customer will continue to be afforded protection associated with the insurance product (e.g. access to the Financial Ombudsman Service (FOS) and Financial Services Compensation Service (FSCS) in respect of the insurance policy, subject to certain eligibility limits³).

CONSULTATION

1.4 This RIA concerns removing freight forwarders' insurance activities from the scope of FSA regulation.

1.5 A consultation seeking views on the proposed changes was launched on 21 December 2006 and closed on 22 March 2007. 14 responses were received to the consultation from individuals, firms or representative bodies. A summary of responses to the consultation is available on HM Treasury's website (www.hm-treasury.gov.uk).

¹ EU Directive 2002/92/EC

² Assuming, of course, that the insurer is itself FSA authorised.

³ This protection is subject to more detailed rules on the jurisdiction of the FOS and the coverage of the FSCS. For instance, only individuals and small businesses are eligible to make claims to the FSCS and the FOS. The eligibility definition of a small business for FSCS claims depends on the type of activity. For the purpose of complaints to the FOS, a small business is one with a group turnover of less than £1 million. Further information on the FOS can be found at www.financial-ombudsman.org.uk. Further information on the FSCS can be found at www.fscs.org.uk

1.6 This RIA sets out the options open and considers the qualitative, and where possible, quantitative costs and benefits. Risks, unintended consequences and any compliance and enforcement issues have also been incorporated as costs and benefits. Competition issues and the impact on small firms have also been considered.

OPTIONS

Do nothing 1.7 As with all proposals for legislation, HM Treasury has considered the option of making no changes. This would mean that freight forwarders' insurance activities remain inside the scope of FSA regulation. However, the Government believes that this option would have a significant impact upon the international competitiveness of the UK's freight forwarding industry. The Government also believes that the risk of consumer detriment in this area is low.

HM Treasury's Statutory Instrument 1.8 HM Treasury is therefore proposing to remove freight forwarders' insurance activities from the scope of FSA regulation through an amendment to the Exemption Order⁴. This Order provides for certain persons to be exempt from the general prohibition on carrying out regulated activities imposed by the Financial Services and Markets Act 2000 (FSMA). Exempt persons are not required to be authorised to carry on regulated activities.

1.9 This proposed approach will exempt freight forwarders from the general prohibition in respect of any regulated activity of the kind specified by the following articles of the Regulated Activities Order⁵ (RAO):

- Article 21 (dealing in investments as an agent);
- Article 25 (arranging deals in investments);
- Article 39A (assisting in the administration and performance of a contract of insurance); and
- Article 53 (advising on investments).

The RAO defines the perimeter of FSA regulation under powers afforded to it by FSMA.

1.10 In practice, freight forwarders manage and organise the transport of the customer's goods and insurance is provided as an optional element of the service. The freight forwarder typically does this through the use of a "master cover" insurance policy. The forwarder purchases this policy directly from an insurance company or through an insurance broker. The freight forwarder holds the master policy in its own name. However, if the customer decides to take up the insurance option, the rights of the policy are passed to the customer so that in the event of loss, or damage to, the customer's goods, the customer can make a claim directly against the insurance policy. This exemption from the scope of FSA regulation is only applicable where the freight forwarder passes on rights under an insurance policy directly to the customer in respect of loss or damage to the customer's goods.

1.11 For the purpose of the legislation, freight forwarders are defined as persons whose principal business is arranging or carrying out the transportation of goods. The Government believes that, where storage firms arrange their insurance activities in the same way as freight forwarders, i.e. where rights under a master cover insurance policy are passed to the customer, these firms should also be exempted from regulation. This is due to the low risk of consumer detriment and also the desire to maintain a consistent approach for firms who

⁴ Part IV of the Schedule to the Financial Services and Markets Act 2000 (Exemption) Order 2001

⁵ Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

conduct both traditional freight forwarding and storage activities. The Statutory Instrument (SI) has therefore been extended to include storage firms within the scope of the exemption from regulation. Storage firms are defined as those whose principal business is storing goods or arranging storage for goods.

1.12 At first, this measure will only apply to commercial customers of freight forwarding and storage firms. The Government will therefore lay a SI that will exempt only insurance activities relating to commercial customers of these firms. The Government does, however, consider that there is a case for extending the exemption to cover retail customers as well as commercial customers, since, somewhat counter-intuitively, it is likely that consumers will receive better redress and protection outside of regulation. Paragraph 1.24 gives further details of this argument.

1.13 However, the Government wants to ensure that freight forwarders and storage firms maintain high standards during the course of their insurance activities. So these insurance activities will only be exempted from regulation once the Government is satisfied that the relevant trade associations have introduced appropriate self-regulation, including an appropriate independent redress mechanism, in order to guarantee sufficient consumer protection. At this point, a second-stage SI will be laid before Parliament to extend the deregulation of insurance activities to retail customers of freight forwarding and storage firms.

1.14 A further technical change to the SI has also been made to clarify that the exemption relates to rights passed to the customer under the freight forwarder's "master cover" insurance policy rather than the limited liability policy held by the freight forwarder.

Other options 1.15 A different legislative approach would be to amend the RAO directly in order to exclude freight forwarders' insurance activities from the scope of FSA regulation. This approach could be used to achieve the same policy intention as that achieved by the SI. However, HM Treasury believes that this approach would be less transparent than its preferred approach outlined above.

COST AND BENEFITS

Groups affected 1.16 The following main groups have been identified as potentially being affected by these proposals:

- freight forwarding firms;
- the logistics industry more widely, including storage firms;
- customers of freight forwarding firms or the logistics industry;
- insurers and insurance brokers involved in the provision of insurance covering loss of, or damage to, the goods of a freight forwarders' customer.

1.17 There are around 2,500 freight forwarding firms in the UK. Freight forwarding as a sector contributes around £16 billion per annum to the UK's GDP and employs around 15,000 people⁶. The UK's storage industry generates revenue of approximately £310 million per annum and employs more than 2,000 staff members⁷.

Benefits 1.18 This measure is deregulatory in nature. Excluding freight forwarders' insurance activities from the scope of FSA regulation will provide a significant benefit to these firms through reduced authorisation and compliance costs. The FSA estimate that they currently

⁶ Source: British International Freight Association (BIFA)

⁷ Source: Mintel survey for the Self Storage Association UK, 2006

authorise the insurance activities of approximately 150 freight forwarding firms. Freight forwarding firms spent around £4million on FSA authorisation fees in 2005⁸ (with costs to individual firms ranging from £1,500 to £160,000). A regulated freight forwarder will incur additional burdens through higher paperwork requirements and the cost of ensuring ongoing compliance with FSA rules. There is also a one-off ‘understanding’ cost that a regulated firm will incur upon authorisation as it becomes familiar with the requirements of regulation. This measure will remove that cost for new entrants to the market.

1.19 Ultimately, these costs will be borne – at least in part – by customers of freight forwarding firms. In an industry where business is highly internationally mobile, the removal of these costs should provide a significant positive impact on the international competitiveness of the UK’s freight forwarding sector.

1.20 For those freight forwarders who have decided not to seek authorisation from the FSA, lost revenue was estimated to total £24million in 2005⁹. The removal of the requirement for FSA regulation of freight forwarders’ insurance activities will allow these freight forwarders to increase their level of business accordingly.

1.21 The Government is also aware of concerns that customers of freight forwarding firms, who have decided to cease their insurance activities in light of the requirement of FSA regulation have experienced higher premiums or difficulties in obtaining suitable insurance cover when approaching insurers or insurance brokers directly. Anecdotal evidence provided by the British International Freight Association (BIFA) suggests that the cost of equivalent cover may be significantly higher in such circumstances. However, a number of respondents suggested that these customers are generally smaller companies or individuals. The Government is also aware of concerns that the number of uninsured goods consignments has increased as the price of cover has increased.

Costs 1.22 This measure is deregulatory and will result in no new costs for the freight forwarding and storage industries.

1.23 FSA regulation provides consumer protection. Ultimately, there is a risk that removing FSA regulation in any area can increase the risk of consumer detriment. However, FSA regulation will still apply to the selling of the original insurance policy to the freight forwarder and, where insurance rights are then passed on to the customer, the customer will continue to be afforded protection associated with the insurance product (e.g. access to the FOS and FSCS in respect of the insurance policy, subject to certain eligibility limits).

1.24 The Government also believes that there is a case to extend the exemption to cover retail customers as well as commercial customers since, somewhat counter- intuitively, it is likely that consumers will receive better redress and protection. This is because, to avoid regulation, many freight forwarding companies have chosen to use a system of extended liability insurance. In the event of a complaint customers will only have a contract with the freight forwarder and importantly, will not have access to the FOS or the FSCS. Under the “master cover” policy commonly used prior to regulation, insurance rights are passed on from the freight forwarder on behalf of the insurer to the client, giving the consumer the right to go directly to the insurer in the event of a claim, as well as being able to use the FOS or FSCS. The protection provided by the FOS and FSCS is subject to a small business eligibility limit, and is not applicable in circumstances where the customer is a larger business. However, the Government will only consider this case further when the relevant sectors have put in place robust measures for self-regulation that include an appropriate consumer redress mechanism. Further details are provided below.

⁸ Source: BIFA

⁹ Source: BIFA

1.25 The Government believes the risk of consumer detriment is low. The role of the freight forwarder or storage firm is, in practice, simply one of passing on rights under the policy to the customer. In addition to this, customers of freight forwarders are generally also commercial entities and this further reduces the risk of consumer detriment. Indicative figures provided by BIFA suggest that the number of transactions on behalf of retail customers is very low and in terms of value it is less than 1%. Whilst the Government is aware that the FOS does look into a number of cases relating to complaints from consumers and small businesses regarding insurance covering the loss of, or damage to, goods or possessions in transit, the FOS have pointed out that the majority of these cases arise from disputes between the insurer and the customer over unpaid claims and the role of commercial freight forwarders has seldom been the subject of complaints. Such cases will remain within the FOS' jurisdiction whether or not freight forwarders are regulated (subject to the small business eligibility limit).

1.26 The Government also understands that in this area it is common for insurers to expect that freight forwarders will conduct their insurance activity in accordance with good insurance practice. Insurers typically maintain the existing (pre-FSA regulation) practice of accepting responsibility for any poor practice by the freight forwarder, whether regulated or unregulated.

1.27 However, the Government wants to ensure that freight forwarders and storage firms maintain high standards during the course of their insurance activities. The Government will therefore use a two-stage approach and will only consider changes to exempt the retail insurance activities of freight forwarding and storage firms once these sectors have introduced and promoted an industry code of practice that will ensure high standards by promoting transparency in connection with the insurance contract and putting in place an appropriate independent complaints mechanism. BIFA has indicated that they will be willing to develop such self-regulation. The Government will also work with other relevant trade associations in the freight forwarding and storage sectors in order to develop codes of practice that will provide sufficient protection for retail customers.

1.28 There is a risk of unintended consequences if this measure can be used to exempt an insurance intermediary from the scope of FSA regulation in an area unrelated to the intended scope of the policy. This exemption is not intended, for instance, to be used to exempt the passing on of rights under a group payment protection insurance policy from a retailer to a customer. The legislation has been deliberately drafted narrowly in order to avoid such unintended consequences.

SMALL FIRMS IMPACT TEST

1.29 There are around 2,500 firms in the UK's freight forwarding sector and BIFA estimate that around 90% of these are small firms. Since this proposal is deregulatory in nature, it is likely that it will have a beneficial impact on these small firms. All but one of the approximately 150 freight forwarding firms whose insurance activities are currently authorised by the FSA are the responsibility of the FSA's Small Firms Division.

COMPETITION ASSESSMENT

1.30 This proposal is likely to have a positive impact on competition in the market for the provision of insurance cover for the loss of, or damage to, goods in transit. Reducing regulatory costs will generally lower the barriers to entry in this market.

ENFORCEMENT, SANCTIONS AND MONITORING

1.31 This measure effectively removes the FSA's responsibility for enforcing regulation of certain regulated activities under the circumstances defined by the legislation. The Government will continue to monitor the insurance activities of freight forwarders.

IMPLEMENTATION AND DELIVERY PLAN

1.32 HM Treasury will take forward laying the Statutory Instrument which is subject to the negative resolution procedure. Subject to Parliamentary approval, it is intended that the revised arrangements will apply as soon as possible. Further legislation exempting freight forwarding and storage firms' insurance activities relating to retail customers may be made once satisfactory codes of practice and complaints procedures are in place.

POST-IMPLEMENTATION REVIEW

1.33 The Government will monitor the insurance activities of freight forwarders. The Government will not hesitate to act if evidence of misselling or consumer detriment emerges as a result of removing freight forwarders from regulation.

SUMMARY AND RECOMMENDATION

1.34 The Treasury has decided to remove freight forwarders' insurance activities from the scope of FSA regulation.

1.35 FSA regulation will still apply to the selling of the original insurance policy to the freight forwarder and, where insurance rights are then passed on to the customer, the customer will continue to be afforded protection associated with the insurance product (e.g. access to the FOS and FSCS in respect of the insurance policy, subject to certain eligibility limits).

1.36 The option of doing nothing was considered, but it was judged that this would have a significant impact upon the international competitiveness of the UK's freight forwarding industry. The Government also believes that the risk of consumer detriment in this area is low.

MINISTERIAL DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.



ED BALLS MP,

ECONOMIC SECRETARY TO THE TREASURY

18 June 2007

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IMPACT ASSESSMENT

TITLE OF PROPOSAL

A.1 Amendment to Part IV of the Schedule to the Financial Services and Markets Act 2000 (Exemption) Order 2001 (the “Exemption Order”) to enable a policyholder advocate to carry out the functions intended in the Financial Services Authority (FSA) rules without being authorised by the FSA.

Purpose and intended Effect

A.2 A reattribution takes place when with-profits policyholders are offered a payment in return for their agreement that they forego future claims on any future excess assets. This can happen when a life insurance company (the "insurer") wants to restructure its with-profits fund. An insurer might decide to opt for a reattribution if, for example, it decided to merge several different with-profits funds into one fund in order to reduce management costs.

A.3 However, there were concerns that there wasn't a representative to act on behalf of the policyholders' interests and negotiate with the insurer. Policyholders were perceived as not getting the best deal. As a result, the Financial Services Authority (FSA) introduced rules that created such a role – the policyholder advocate. The policyholder advocate is an independent figure representing policyholders' interests to the insurer (and where required, to the FSA and others). FSA rules require the policyholder advocate to negotiate the terms of the reattribution with the insurer on behalf of policyholders in relation to the value of benefits the insurer is offering to them. He will then publish a report setting out his views on the reattribution, including whether he considers the reattribution proposals to be in the interests of policyholders.

A.4 Advising on and arranging deals in rights under contracts of insurance are regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the “RAO”) and a person carrying on such activities is therefore required either to be authorised by the FSA or exempt from authorisation. In order to carry out his role, it is likely that the policyholder advocate will be carrying out regulated activities. The risks involved in carrying out such a role without the appropriate authorisation or exemption are significant and are discussed in more detail in the consultation document.

A.5 As a result, the Government proposes to amend Part IV of the Schedule to the Exemption Order to enable a policyholder advocate to carry out the functions intended in the FSA rules without being authorised by the FSA. In particular, the proposed amendments would exempt a policyholder advocate from requiring authorisation in respect of the regulated activities specified by articles 25 and 53 of the RAO, which relate to arranging deals in, and advising on, investments.

CONSULTATION

A.6 To ensure that as many people associated with the reattribution process have the opportunity to comment, copies of the consultation document were sent to:

ALICO

APCIMS
Association of British Banks
Association of British Insurers
Association of Independent Financial Advisers
Aviva plc
AXA
Britannic Assurance plc
British Bankers' Association
Building Societies Association
Clerical Medical
The Faculty and Institute of Actuaries
The Financial Ombudsman Service
The Financial Services Authority
The Financial Services Consumer Panel
The Financial Services Practitioner Panel
Friends Provident Life and Pensions Ltd
HBOS
Law Society
Legal and General
Lloyds TSB Bank plc
The National Association of Citizen Advice Bureaux
Nationwide Building Society
Pearl Assurance
Phoenix Life Group
Prudential
Scottish Life
Scottish Widows
Skandia
The Small Business Practitioner Panel
Standard Life
Sun Alliance Insurance International Limited
Which?
Zurich

A.7 The consultation provoked nine responses.

Authorise the role

Consultation responses

A.8 There was widespread agreement on whether or not the policyholder advocate needed to be authorised by the FSA. Eight respondents agreed that a policyholder advocate carrying out the functions intended in the FSA rules did not need to be authorised by the FSA. One respondent did not comment.

Government response

A.9 This proposal will remain unchanged as a result of industry support.

Exempt from requiring authorisation in respect of regulated activities specified in articles 53 and 25 of the RAO

Consultation Responses

A.10 Seven respondents agreed that an exemption from authorisation in respect of the regulated activities specified in articles 25 and 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 was the most appropriate solution. However, two of the seven respondents didn't share the Government's concerns about a full exemption from FSMA providing scope for roles other than a policyholder advocate to be exempt from FSMA. It was also suggested by two respondents that the exemption should apply both to nominated and appointed policyholder advocates.

Government Response

A.11 Regarding the suggestion that the exemption should apply equally to both nominated and appointed policyholder advocates, it is the Government's view that an exemption should not be necessary for a nominated policyholder advocate.

A.12 We assume that a "nominated" policyholder advocate is used by the respondents in the context of the person being in transition as having been identified for the role and in the period before formal approval by the FSA or the appointment by the insurer.

A.13 The transitional position of a policyholder advocate is most likely to be at a very early stage in the reattribution process. As such, the nominated policyholder advocate should not be carrying on any regulated activity, but is instead expected to start preparations for the role. Meetings and consultations that the policyholder advocate may hold with policyholders are, as the Government understands, meant to gather information with a view to assisting negotiations with the insurer. We are of the view that the policyholder advocate should not be considered to be advising or arranging until later on in the process when the report on the reattribution proposal is published/distributed.

Full exemption from authorisation

Consultation Responses

A.14 Two respondents felt the policyholder advocate should be exempt from the whole of FSMA on the basis that this is already a very specific role required by the FSA's rules.

Government Response

A.15 The Government maintains that there does not seem any necessity to apply the full exemption from general prohibition to the role and that doing so might risk providing scope for roles other than a policyholder advocate to be exempt from FSMA. Additionally, general consensus of responses supported a more limited exemption.

Whether current safeguards to protect consumers are sufficient

Consultation Responses

A.16 Six respondents felt that the safeguards offered within the existing FSA rules and the legal process for making a reattribution provided consumers with enough protection. Two did not respond.

A.17 One respondent felt that there were a number of additional safeguards that should be in place to protect policyholders. The main proposals were:

- Access to redress – policyholders should retain a right of redress against the insurance company for advice provided by the policyholder advocate concerning the reattribution proposals. They highlight the importance of access to the Financial Ombudsman Service (FOS), in respect of complaints about the reattribution process and the role of the policyholder advocate. They believe that this will strengthen the safeguards in the process as the insurer will not wish the policyholder advocate to recommend what turns out to be a bad deal to policyholders as the insurer will ultimately retain the liability for this advice
- Breadth and depth of the advice – They feel that it is important to clarify the breadth and depth of the advice being provided by the policyholder advocate. They recommend that the policyholder advocate and the FSA, in consultation with consumer groups, should consider this issue.

Government Response

A.18 With regard to maintaining consumer access to the FOS in respect of complaints against the policyholder advocate, we do not believe that this is necessary or appropriate. This is supported by the FOS's response to the consultation which outlined that it had not seen any evidence of actual or potential consumer detriment in the activities of policyholder advocates and felt that it was difficult to foresee any circumstances under which it would be appropriate for the FOS to handle a complaint involving a policyholder advocate. The FOS felt that this view was supported by both the regulatory and court procedures that would already be in place as well as the separate FSA/FOS wider implications process that exists to cater for such circumstances. Additionally, the FOS considered that any consumer detriment that might arise would be in relation to the activities of the insurer itself, not the policyholder advocate, in which case there would be an avenue for complaint against the insurer under existing rules.

A.19 The Government is inclined to agree with this assessment and believes that the safeguards set out in the consultation document should be sufficient to protect consumers. Additionally, to strengthen the existing safeguards, the FSA is simultaneously considering amendments to its Conduct of Business (COB) rules on additional information that may need to be provided to policyholders so that they are aware of the implications of the policyholder advocate not being an authorised person under FSMA.

A.20 It was also suggested that policyholders should retain the right of redress against the insurer for advice provided by the policyholder advocate. The Government's view is that the policyholders' right of redress against the insurer will not be affected by the proposed legislative amendments. The rights policyholders have against the insurer will depend on the terms of the policy, and to an extent, the offer document in the reattribution so far as rights against the insurer relating to the reattribution are concerned. The policyholder advocate generally does not have contractual relationships with the policyholders. It seems that any right of action against the policyholder advocate might be governed by common law tort, which generally depends on establishing that a duty of care

is owed by the person giving the advice to those to whom advice is given and a breach of that duty if advice turns out to be negligent. In practice, it is likely that the terms of appointment for a policyholder advocate would include a full or partial indemnity by the insurer in respect of certain claims that may be made against the policyholder advocate in connection with the performance of his functions. There is also the right to action for damages on breach of a rule by an authorised person under s150 of FSMA that policyholders who have suffered loss as a result of the breach might be able to avail themselves depending on the circumstances.

A.21 A further point raised in the consultation was around clarifying the breadth and depth of the advice being provided by the policyholder advocate. In a world of principles-based regulation, the FSA is not proposing to introduce prescriptive rules in its handbook on this matter. It would also not be able to prescribe such rules to the policyholder advocate as the Government is proposing that the policyholder advocate should not be subject to the FSA's rules.

A.22 The FSA is currently making changes to its Conduct of Business Handbook to move to higher-level rules in some areas, including the rules governing the role of the policyholder advocate where this did not affect, or improved outcomes for consumers. One of the proposed amendments sets out that the role of the policyholder advocate should include *"telling with-profits policyholders, or each group of with-profits policyholders, with reasons, whether the firm's proposals are in their interests"*. Additionally, these proposed new rules emphasise that *"a firm must ensure that every policyholder that may be affected by the proposed reattribution is sent appropriate and timely information about the reattribution proposals and how they affect the relevant policyholders, including an explanation of any benefits they are likely to receive and the rights and interests that they are likely to be asked to give up and the policyholder advocate's views on the reattribution proposals and any benefits the relevant policyholders are likely to receive and the rights and interests that they are likely to be asked to give up"*.

OPTIONS

Do nothing

A.23 There is, of course, the option to do nothing. We do not think that this is a sensible way forward given the possibility of agreements between the insurer and its with-profits policyholders being invalidated and the implications for the policyholder advocate if he were to act without authorisation or exemption (i.e. committing a criminal offence). Additionally, there was no support for this option.

Alternatives to regulation

A.24 Alternatives to regulation are unlikely. This role was introduced into FSA rules in 2005. When the FSA was reviewing the rules, it did consider whether it might carry out the role of the policyholder advocate, but it was decided that the role should be objective and FSA should oversee the process. As a result, the policyholder advocate is an independent figure who has either been nominated or approved by the FSA. Given the role, the proposed policyholder advocate should be free from any conflicts of interest which may be detrimental to the interests of the policyholders he-represents. The policyholder advocate must also have the skills and knowledge required for the role.

Other Options

Authorise the role

A.25 Authorising a policyholder advocate so that he is subject to FSA rules brings with it a number of practical considerations, which suggest that this might not be a viable solution. They are:

- the policyholder advocate's ability to maintain professional indemnity insurance (including minimum limits of indemnity per year of between €500,000 to €1 million for a single claim)¹⁰. Given we expect the policyholder advocate to be an individual rather than a firm, getting such insurance may pose difficulties in terms of availability and costs, amongst other things. Maintaining adequate financial resources could also inflate his expenses considerably – this would have to be funded by the insurer and may result in reduce benefits being offered to policyholders;
- his ability to satisfy and continue to satisfy the minimum conditions, known as the threshold conditions¹¹, in order to become authorised (e.g. ensuring a firm has adequate resources, which include financial resources, non-financial resources and means of managing its resources; for example, capital, provisions against liabilities, holdings or access to cash and other liquid assets, human resources and effective means by which to manage risks). Again, being an individual rather than a firm, in a relatively short-term function, will make this more difficult; and
- there are other resource requirements that may be difficult to meet, such as when complying with high level systems and control requirements set out in FSA's Senior Management Arrangements, Systems and Controls (SYSC) rules. As a result waivers or modifications of the FSA rules may need to be put in place. It is very likely that a significant number of waivers will be required, which will be a very time intensive process.

A.26 Furthermore, it may not be appropriate for an authorised person regulated under the FSA rules to be appointed, for all intents and purposes, to perform a regulatory function on behalf of the FSA. It could make it more difficult for the FSA to intervene or raise objections later on in the reattribution scheme if it had concerns.

A.27 The policyholder advocate also needs to be independent of any firm and act in the best interest of the policyholder. It could be argued that the FSA rules that would apply to him as an authorised person could limit his ability to do this.

A.28 On the basis of the above arguments, we do not consider that authorising the role of policyholder advocate is the most appropriate solution.

Exempt from requiring authorisation in respect of regulated activities specified in articles 53 and 25 of the RAO

A.29 We propose that the role of policyholder advocate should be exempt from authorisation under FSMA in respect of the regulated activities he is likely to be carrying on, in particular Articles 53 and 25 of the RAO. Keeping the exemption in this way has the advantage of creating legal certainty for the policyholder advocate that he would not be

¹⁰ Assuming the policyholder advocate may be authorised in a role analogous to an insurance intermediary which carries out the regulated activities in Articles 25 and 53 of the RAO.

¹¹ Schedule 6 to FSMA

committing a criminal offence and for the insurer and policyholders that any agreement between them would not be invalidated by the policyholder advocate carrying out this role. At the same time it ensures that the exemption is no wider than necessary so that the possibility of something unintended falling within the scope of the exemption is limited.

A.30 This option also has the advantage that the policyholder advocate can carry out the functions intended in the Financial Services Authority (FSA) rules without his independence being limited by them. This is because the activities of the policyholder advocate may be reasonably regarded as an extension of the FSA's regulatory function and as being carried on for the purpose of enabling the FSA to meet its statutory objective of protecting consumers.

A.31 There are also a number of practical considerations that make it more desirable to exempt than authorise the role. The fact that a policyholder advocate is an individual without the resources often available to a firm is particularly significant. Such practical hurdles could prevent people taking on the role entirely; such as maintaining professional indemnity insurance (including minimum limits of indemnity per year of between €500,000 to €1 million for a single claim) and an ability to satisfy and continue to satisfy the minimum conditions, known as the threshold conditions¹², in order to become authorised (e.g. ensuring a firm has adequate resources).

Full exemption from authorisation

A.32 A more radical option would be to exempt the policyholder advocate from the general prohibition contained in section 19 of FSMA. There does not seem any necessity to exempt the role from the whole of the general prohibition. Doing so might risk providing scope for roles other than a policyholder advocate to be exempt from FSMA. This could include people who might seek to become self-appointed policyholder champions or people who provide generic advice.

COSTS AND BENEFITS

A.33 The benefits are that legal certainty would be provided for all involved in the reattribution process. At the same time, the FSA would maintain its key role in the reattribution process and continue to enforce the rules in relation to the process.

A.34 We do not anticipate any costs arising from this proposal. A small number of consultation response addressed the issue of costs. They outlined their general concerns about the costs involved should the policyholder advocate be subject to the FSMA regulatory regime. No specific data was supplied.

A.35 There is likely to be a nominal cost associated with the FSA's proposed amendments to its Conduct of Business (COB) rules that set out the additional information that may need to be provided to policyholders so that they are aware of the implications of the policyholder advocate not being an authorised person under FSMA. The FSA is consulting on these amendments and will hopefully be in a better position to understand the level of these costs following its consultation.

Summary costs and benefits

Summary costs and benefits table

¹² Schedule 6 to FSMA

Option	Total benefit per annum: economic, environmental, social	Total cost per annum: - economic, environmental, social - policy and administrative
1	<p>Authorise the role – Policyholder advocates would be authorised by the FSA, which would subject the policyholder advocate to FSA rules, and supervisory and enforcement powers. Policyholders may access the Financial Ombudsman Service in the event of a dispute with, or about, the policyholder advocate.</p>	<p>Policyholder advocate would need:</p> <ul style="list-style-type: none"> • professional indemnity insurance (including minimum limits of indemnity per year of between €500,000 to €1 million for a single claim) • to satisfy and continue to satisfy the minimum conditions in order to become authorised (e.g. ensuring a firm has adequate resources). <p>As a result, it is likely that very few people will take on the role in any meaningful way.</p>
2	<p>Exempt from requiring authorisation in respect of regulated activities specified in articles 53 and 25 of the RAO - Policyholder advocates would not be bound by the practical requirements that accompany FSA authorisation. This option has the advantage that he can carry out the functions intended in the Financial Services Authority (FSA) rules without his independence being limited by them.</p>	<p>Policyholders would not have recourse to the Financial Ombudsman Service in the event of a dispute with the policyholder advocate (but will still have recourse to complain about the insurer in respect of the way the reattribution process had been run or about the outcome)</p> <p>FSA are simultaneously considering amendments to their Conduct of Business (COB) rules on additional information that may need to be provided to policyholders so that they are aware of the implications of the policyholder advocate not being an authorised person under FSMA.</p>
3	<p>Full exemption from authorisation – benefits as above.</p>	<p>Costs as above but additionally we run the risk of exempting a wider group of individuals/firms that are not intended to be exempt from FSA authorisation.</p>
4	<p>Do nothing - None</p>	<p>The implications for the policyholder advocate are serious were he to act without authorisation or exemption (committing a criminal offence and invalidating any agreement between the insurer</p>

Summary costs and benefits table		
Option	Total benefit per annum: economic, environmental, social	Total cost per annum: - economic, environmental, social - policy and administrative
		and the policyholder).

SMALL FIRMS IMPACT TEST

A.36 There are currently 54 life insurers carrying out with-profits business. Of these, a significant number are likely to be affected by the proposed rule changes relating to the role of policyholder advocate. But in practice, only larger proprietary firms that are still open to new business are likely to carry out a reattribution.

A.37 It is unlikely that these proposals will impact on small firms, as they are less likely to carry out reattributions for a number of reasons:

- As a function of their smaller size, inherited estates are less likely to build up in smaller firms. So the practical issue of paying out substantial accumulated inherited estates doesn't arise as often.
- Many of the smaller with-profits funds are operated by friendly societies, which are mutuals and don't have any shareholders. They therefore would not be affected by any change to the policyholder advocate rules.
- The costs involved in a reattribution exercise can be quite significant and so may be sufficiently disproportionate to prevent many small firms going down this route.

COMPETITION ASSESSMENT

A.38 We do not envisage any detrimental effects on competition arising from this amendment. The impact will be minimal as the changes are quite small and affect a small number of financial services companies.

ENFORCEMENT, SANCTIONS AND MONITORING

A.39 As the proposed amendment is to exempt a role from authorisation under FSMA, it will not require enforcement or sanctions. However, the FSA will continue enforce its rules relating to the reattribution process and the firms' role in it. FSA and HMT will also monitor whether the process is working as intended.

IMPLEMENTATION AND DELIVERY PLAN

A.40 The delivery objectives and outcomes that the Government is seeking to achieve through this amendment centres on providing legal certainty to all parties involved in the reattribution process. At the same time, the FSA should maintain its key role in the reattribution process and continue to enforce the rules in relation to the process.

A.41 The measure of success will be that the reattribution process can take place in an environment of legal certainty and the policyholder advocate will be able to fulfil the consumer protection role envisaged in the FSA's rules.

A.42 We have been in close contact with the FSA during this process as the amendment impacts on a role that is set out in FSA rules. It is critical that this amendment is in place as soon as possible ahead of any policyholder advocate undertaking the regulated part of the role. The amendment will come into effect ahead of the October Common Commencement date. This has been agreed with the BRE.

A.43 The FSA is additionally considering amendments to its Conduct of Business (COB) rules on additional information that may need to be provided to policyholders so that they are aware of the implications of the policyholder advocate not being an authorised person under FSMA. These amendments are until 5 June 2007 being consulted on in the FSA's Consultation Paper 07/8, Quarterly Consultation (No. 12) Chapter 7. The proposal would mean that firms would need to add a brief disclosure to the information they already send to policyholders during a reattribution exercise. As a result, the FSA considers the compliance costs for firms resulting from the proposal would be of minimal significance. [Michelle, could you please put a line in about where this has got to and a bit about costs (which I don't think you anticipated to be large)]

A.44 It is very unlikely that there will be an issue around industry complying with the proposal as it is an exemption from regulation. Nonetheless, the FSA will ensure compliance by industry through their rules on the reattribution process and the role of the policyholder advocate.

A.45 Stakeholders have been involved throughout the development of these proposals. As noted above, the FSA is consulting further on the changes to its rules. The FSA is also in touch with industry and consumer views through the independent panels that have been set up for this purpose. These are the: Practionner Panel, Consumer Panel and Small Business Panel.

Post-implementation review

A.46 Both the Treasury and the FSA are committed to carrying out a post-implementation review three years after the implementation of the proposals. The review will consider whether:

- the policy objectives have been met;
- impacts have been as expected, including costs and benefits; and
- there have been any unforeseen and unintended consequences.

A.47 If the above criteria were not being met, HM Treasury and the FSA would consider what further action should be taken, if necessary. There is unlikely to be further scope to simplify the specific proposals as it is already deregulatory and will be included in HM Treasury's simplification plan for 2007.

A.48 It is not appropriate to consider using a "sunset clause" as such a step would mean the default reintroduction of legislation. These measures are meant to have the very opposite effect.

Declaration and publication

A.49 I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

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