

Mitigating Risk Relating to Appointed Representatives (and Future Reforms) and Conflicts of Interests

Rachel McDonnell and Liam Burnett, Partners at Mills & Reeve presented a technical forum that focused on the FCA's review of the Appointed Representatives ("AR") regime, as an update to the forum held in May 2023.

This bulletin summarises the principal points, but a full recording and slides are available on the Member Portal.

WHAT ARE APPOINTED REPRESENTATIVES

Appointed Representatives are exempt persons seeking to conduct regulated activities on behalf and under the responsibility of an authorised firm (the Principal), without having to be directly authorised by the FCA.

A Principal of an AR is a fully authorised firm and is responsible for the AR's actions or omissions in carrying on the business for which it has expressly accepted responsibility. A number of new rules were introduced by the FCA in December 2022, a synopsis of which includes, but is not limited to:

- Having a written agreement with the AR, setting out clear business parameters, and the nature and extent of the regulated activities to be carried out by the AR.
- Due diligence of an AR prior to appointment, to ensure they are fit and proper, financially stable and suitable to carry out regulated activities.
- Regularly reviewing information on the ARs' activities, business and senior management functions.
- Taking reasonable steps to ensure ARs act within the scope of their appointment agreement.
- Ensuring that at all times a Principal has the skills and resources to oversee the AR including any substantial changes to the business conducted.
- Monitoring the AR to ensure that it continues to meet the necessary standards to conduct regulated activity.

The FCA had previously identified that Principals were responsible for up to 400% more supervisory cases than non-principal firms. There was also a concern that there remained a lack of understanding of structure of the regime and regulatory expectations.

FCA UPDATES 2024

The FCA initiated a progress review to ascertain the understanding and implementation of the new rules. An initial update was provided in April 2024, which included data from a survey sample of Principals, with 96% of respondents indicating they were confident that they were adhering to the regulations well. Further investigation, however, found that this was not necessarily the case, particularly in respect of Principal annual self-assessments and AR annual reviews.

The main points raised were:

Annual Principal self-assessment – This should be a single document, include clear management information and consider any output from file reviews, AR visits and customer feedback.

Monitoring AR growth – Principals need to understand the changes in risk profile and should include visits to discuss the AR's business model, growth and target markets. Principals should also review any management information provided by the AR and have an agreed exit strategy in place.

AR Annual review – This should not be a tick box exercise or rely on unverified information from the AR. Reviews should consider the AR's systems and controls, staff numbers, approved persons and training. File checking and policy reviews are recommended and should include an analysis of available Management Information. The exit strategy should also be reviewed and updated if appropriate.

Monitoring the scope of AR activities – The terms of the AR Agreement need to be clear about what activities the AR is entitled to undertake. Principal firms should also conduct sample file checks, review call scripts, and attend regular review meetings to check compliance, taking a risk-based approach.

The FCA considers that the approach to monitoring and management of ARs should be one of continuous improvement, through which gaps are identified, rated and remedied. Principals must have a robust understanding of all their AR's activities and consider the level of evidence required to demonstrate compliance.

FUTURE REFORM

The FCA has made it clear that the issue of how Principals control their ARs is not going away and will form part of its regulatory plans for some years to come. The FCA and HMRC have in the past considered implementing additional measures to reduce the potential harm to customers. Although there are no immediate plans to change the current regime, options that have previously been discussed include:

- Banning or restricting regulatory hosting.
- Restricting the size of an AR.
- Actions in relation to overseas ARs.
- Enabling the FCA to investigate ARs directly, although it is unclear whether this is feasible.

CONFLICTS: IN WHICH CAPACITY ARE YOU ACTING?

Effective management of conflicts of interest is a regulatory requirement and is covered under both Principles for Business 6 (Treating Customers Fairly) and 8 (Conflicts of Interest). It is, therefore, important that Members understand who their client is and the capacity in which they act at any given time.

Intermediaries may act in a variety of capacities (retail/producing broker, wholesale/placing broker and / or coverholder/MGA) owing duties to different entities (policyholder, retail/producing broker and / or the insurance principal/capacity provider). It is not uncommon for intermediaries to perform at least two or more of these duties during the arrangement of a single policy, and in doing so owe different duties to different principals.

To avoid potential pitfalls which increase the risk of a professional liability claim, Members should be aware of situations where they act in a dual capacity. In circumstances where there is a potential

conflict, Members should bear in mind that under the Lloyd's Code, the duties owed by the broker to the policyholder are likely to prevail.

RISK MITIGATION

Acting in a dual capacity – brokers should have information barriers in place to protect the respective client when acting as *both* broker and coverholder.

When carrying out dual roles, it is possible that pre-inception information passed to the broker, may not be passed to a separate individual acting in a different capacity in the same placement transaction (i.e., such as coverholder). In this example, the risk that the coverholder's insurer principal is either deemed to know the information submitted or ought to know it (as possessed by its agent) is increased. Therefore, when acting in a dual role there must be a clear separation of functions, whether by different office or legal entity. This will help to avoid any suggestion that a broker has not fulfilled its duty to disclose sufficient information to the insurer and/or that the coverholder has breached the terms of the authority delegated to it.

Remuneration/Commission and ownership structures – Issues may arise where the intermediary (broker) arranges potentially less suitable (or even inappropriate) cover in circumstances where it also earns commissions in its capacity as coverholder.

Issues may also arise when the broker pressures the coverholder to accept a risk that is outside the scope of the binding authority agreement, potentially causing a breach of its terms and conditions.

Claims must be managed fairly to ensure that there is no conflict with any potential profit commission.

Disclosure -- Disclosures to the client regarding dual roles must be clear, honest and not misleading.

CONCLUSIONS

The FCA takes the view that when an AR fails in its duties for whatever reason, the Principal is always responsible.

Principal firms must have procedures in place to monitor and manage their ARs and also have sufficient resources in place to conduct these tasks effectively.

AR agreements must be clear so that all parties are aware of the full extent and limitations of their duties and responsibilities.

Principals must be able to evidence that they recognise, understand and manage conflicts of interest.

This bulletin is for general information purposes only and does not provide a comprehensive or complete statement of the law relating to the issues discussed nor does it constitute legal advice. In addition, by its nature, this bulletin may be superseded by subsequent regulatory or legal developments. Professional advice should be sought where appropriate in relation to any particular circumstances.

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