

Global Insurance Focus

An overview of the latest developments in the global insurance and reinsurance industries

Issue 7: December 2017

Highlights in this issue include:

Insurance Linked Securities Regime

VAT treatment of fund
management services

As rebrands go, SIMR to SM&CR
sounds simple; but there is a catch
for insurers

Non-consumer disclosure reforms in
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China cybersecurity law

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Insurance Linked Securities Regime

*By Adam Levitt, Nick Gardner
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On 20 July 2017, HM Treasury (HMT) published The Risk Transformation Regulations 2017 (the Regulations), which introduce a new regime for insurance linked securities (ILS) in the UK. The Regulations received Parliamentary approval on 29 November 2017.

The Risk Transformation (Tax) Regulations 2017 (the Tax Regulations) were also published on 20 July 2017 and reissued in an amended form on 13 October 2017, and also received Parliamentary approval on 29 November 2017.

The publication of the Regulations and the Tax Regulations was accompanied by an explanatory paper setting out how the Regulations and the Tax Regulations reflect responses to the consultation on the proposed draft regulations published in November 2016 (the Consultation).

On 1 November, the Prudential Regulation Authority (PRA) published its Policy Statement on the authorisation and supervision of insurance special purpose vehicles (ISPVs), PRA PS26/17 (the Policy Statement), and related Supervisory Statement, PRA SS8/17 (the Supervisory Statement).

We have reported on the earlier proposals in previous Ashurst insurance publications.¹

In this article we highlight some of the key updates that have been made to the Regulations and the Tax Regulations to reflect the feedback received on the Consultation, as well as the main changes in the Policy Statement.

Notification of creation of new cells

Some respondents to the Consultation raised concerns about the proposed requirement to notify the PRA prior to the creation of new cells in a Protected Cell Company (PCC).² In response to the feedback received, the Regulations now provide for a post-transaction notification regime.

Under the new regime, when a prospective ISPV applies to the PRA for permission to perform a regulated activity under section 55A of the Financial Services and Markets Act 2000, it is required to define its approach to the creation of new cells or risk transfer deals. If the PRA authorises the ISPV's

¹ These can be accessed at: <https://www.ashurst.com/en/news-and-insights/legal-updates/a-response-to-consultations-on-the-regulatory-framework/> and <https://www.ashurst.com/en/news-and-insights/legal-updates/insurance-linked-securities---a-closer-look-at-the-proposals-for-a-new-uk-regime/>.

² A PCC comprises a core, which assumes the administrative function of the PCC, and any number of cells which are required to manage the ILS deals that the PCC takes on.

proposed approach, the ISPV may carry out these activities in the future without the need for further authorisation, provided that the ISPV notifies the PRA within five days of any new assumption of risk.

While the post-notification regime for the creation of new cells is a marked improvement, the authorisation process is still anticipated to be six to eight weeks for non-complex, single-transaction ISPVs, and possibly longer for PCCs. Consequently, some other jurisdictions will benefit from a potential speed-to-market advantage.

Arrangements between cells

Respondents to the Consultation asked that arrangements between cells be permitted to facilitate, for example, tranching of risks among different groups of investors. The Regulations now include certain provisions to facilitate such arrangements, although these are subject to strict procedural requirements to ensure that the segregation between cells within the PCC remains uncompromised.

Where cells are linked by arrangements made between them, they form a “group of cells” for the purposes of the Regulations. A group of cells can only be used to provide cover for one particular risk transfer at any one time.

Each contractual arrangement for risk transfer must satisfy the fully funded requirement (as to which, please see below) and each cell must remain appropriately ring-fenced. Accordingly, the Regulations require PCCs to keep records and accounts which distinguish between the assets and obligations of each cell and, when two cells enter into arrangements with each other, the accounts must treat such arrangements as if they were set out in a contract made between the two cells.

Where a PCC intends to make use of arrangements between cells, a proposal should be included at the authorisation stage or at a subsequent application to amend its regulatory permissions. Any intra-cell arrangement is subject to the prior written approval of the directors of the PCC, the undertakings from whom the PCC assumes the relevant risk and all persons holding investments issued by the PCC on behalf of the relevant cells. A PCC is also required to notify the PRA within five working days of making the arrangement.

Offers to the public

Some respondents to the Consultation raised concerns that the restriction on offering ILS securities to “non-qualified investors” would cause problems when issuing ILS bonds on the global bond markets, as global bond markets are not restricted to sophisticated investors.

The Regulations retain this restriction, but now define “qualified investor” by reference to the Markets in Financial Instruments Directive II.

The Regulations require issuers to “take such steps as are reasonable” to prevent their ILS subsequently being offered to non-“qualified” persons. Therefore, issuers will need to include wording designed to limit subsequent sales. Query whether there is anything else they could reasonably do: guidance would be helpful.

Directors’ duties

The Regulations replicate the duties of directors found in the Companies Act 2006 (the Act), subject to certain modifications to section 172 of the Act whereby the directors of the PCC have a duty to act fairly between the shareholders of each separate cell of the PCC, rather than between the shareholders of the PCC as a whole.

In response to the feedback received from some respondents, PCC directors are now also under a duty to act in accordance with any “enforceable” arrangements between cells. The duty is owed to the PCC as a whole, so any member of the PCC is be able to enforce it.

PRA Policy Statement and Supervisory Statement

The PRA will only carry out an assessment as to the fitness and propriety of any shareholder with 10 per cent or more of the voting rights in an ISPV, or with “significant influence” over it. Otherwise, it will be up to the ISPV to show to the PRA that it has a “framework” for assessing holders of 10 per cent or more of the capital (but without 10 per cent of the voting rights or significant influence). In relation to a PCC, holdings of interests in cells, irrespective of size, will not need to meet the fit and proper test.

The requirement (under the Solvency II Delegated Regulation) that an ISPV be “fully funded” has given rise to some debate. The PRA has now clearly stated that contingent assets would not help meet the test (even where they would qualify as “ancillary own funds” of a (re)insurer).

Also, the PRA has stated that an “ISPV cannot rely on a limited recourse clause as an alternative to holding assets the value of which is equal to or in excess of its aggregate maximum risk exposure (AMRE)”. A limited recourse clause can, however, be used “as a means of mitigating” the risk that the ISPV ceases to be fully funded. The AMRE must be “determinable” at all times – whether as a fixed amount or one that derives from a model – so that the risk transfer is clear.



Tax

The tax regime for ISPVs includes bespoke corporation tax and interest withholding tax exemptions for the ISPV. These tax exemptions will be lost if certain conditions are breached. There are also specific provisions restricting the use of tax losses made by an ISPV. The regime applies to an ISPV only if substantially all of the insurance risk transformation activity carried out by that ISPV relates to business other than basic life assurance and general annuity business.

Tax exemptions

A corporation tax exemption will be given to an ISPV in relation to any profits arising from the activity of insurance risk transformation other than:

- a. administrative or management activities; or
- b. holding investments in excess of the amount “reasonably required” to satisfy the fully funded requirement (as discussed above) for the ISPV or the cell (if the ISPV is a PCC).

The corporate tax exemption is subject to a 90-day grace period after the satisfaction of all liabilities under a contract of insurance, during which investments which were reasonably required to satisfy the fully funded requirement in respect of risks assumed under that contract can still qualify for the exemption.

There is a complete withholding tax exemption for any payment of interest made to investors in relation to ILS.

The adoption of a blanket exemption for insurance risk transformation activities is to be welcomed and its simplicity is much more attractive than the securitisation regime which was considered as an alternative in the Consultation. ISPVs will obviously be concerned if HMRC takes a restrictive approach to the amount of investments that is “reasonably required” to satisfy the fully funded requirement: guidance on the interpretation of this would be helpful. The extension of the grace period from 30 to 90 days, starting from the satisfaction of all liabilities under the relevant contract rather than from the date when the investments ceased to be reasonably required, is a positive development stemming from the Consultation.



The exemption from interest withholding tax is important to ensure that UK ISPVs will be competitive with ISPVs in other jurisdictions such as Bermuda or the Cayman Islands. No equivalent dividend withholding tax exemption is required as the UK does not impose a withholding tax on dividend payments.

Removal of tax exemptions

If either of the following conditions is satisfied at any time in an accounting period, the exemptions referred to above will not apply in that accounting period or any subsequent one:

- a. the ISPV is liable to a penalty for failure to deliver a tax return or for an error in a tax return; or
- b. having regard to all the circumstances, it would be reasonable to conclude that the purpose or one of the main purposes of the insurance risk transformation, or the arrangements which the insurance risk transformation forms part of, is to secure a tax advantage for any person.

The conditions for the withdrawal of the tax exemptions have, in line with responses to the Consultation, been significantly relaxed since the first draft of the Tax Regulations. The exemptions may be relied on notwithstanding that investors connected to the ceding insurer hold 10 per cent or more of the securities, so as not to obstruct insurers which provide seed capital to ILS funds. The scope for withdrawal of the favourable tax treatment if

the ISPV incurs a penalty for tax non-compliance has been significantly reduced: this will apply only in particularly serious cases, such as three successive failures to deliver a tax return, or deliberate inaccuracies.

Loss restrictions

Where an ISPV is a PCC, for loss relief purposes the core and each cell will be treated as separate companies and they will not be eligible to surrender or receive surrenders of group relief or consortium relief among themselves.

The ring-fencing of losses in an ISPV is understandable given the corporation tax exemption.

Concluding thoughts

The regime has taken some useful steps forward, such as the dropping of the proposal that ISPVs would have to go through a prior notification process for new cells. The more generous tax treatment should make UK ISPVs more competitive against those based in low-tax jurisdictions. However, the location of the vehicle onshore may present some challenges from a VAT perspective, as, when services supplied by advisers or other professionals to the transformer vehicle are not exempt financial services, they are likely to be treated as standard-rated supplies for VAT purposes. The transformer vehicle (SPV) is unlikely to be able to recover this VAT.

The main challenge that sponsors will face is ensuring that the ISPV remains fully funded, especially where the liability derives from an actuarial model.



UK

VAT treatment of fund management services

By Nick Gardner and Vicky Brown, UK

A recent decision of the First-tier Tribunal and guidance from HMRC have restricted the availability of VAT exemptions for fund management services.

The *BlackRock*¹ case dealt with the VAT treatment of investment software provided to an investment management group advising both special investment funds (SIFs) and non-SIFs, holding the supply to be a single, standard-rated supply notwithstanding that SIFs – the provision of management services which is exempt from VAT – were among the recipients of the supply. Meanwhile, in light of the recent emergence of a clear trend in EU case law towards treating defined contribution pension funds as SIFs and defined benefit pension funds as non-SIFs, HMRC has taken the decision to cease allowing insurers to treat their supplies of pension fund management services as exempt under the insurance exemption.

This article will examine the detail of these decisions, and consider the consequences for the fund management sector.

¹ *BlackRock Investment Management v HMRC* [2017] UKFTT 633

BlackRock

In *BlackRock Investment Management v HMRC* [2017] UKFTT 633 (15 August 2017), the First-tier Tribunal held that the provision of investment analysis services via computer platform can, in principle, fall within the exemption for the management of SIFs.

However, the services here were primarily used for the management of non-SIFs and, as the fund management services could not be split into separate supplies to SIFs and non-SIFs, the supply of these services remained standard-rated.

Asset management groups that manage both (i) ICVCs, AUTs, investment trusts or other SIFs; and (ii) non-SIFs (e.g. managed accounts or limited partnership funds) might want to consider whether there is a more structural solution to the issue raised in this case.

Nature of the services provided

The services at issue here were provided to BlackRock and its fellow VAT-group fund management companies by a US company.



The services consisted of an investment management computer platform called “Aladdin”, which provides portfolio managers with performance and risk analysis and monitoring to assist in making investment decisions, monitors regulatory compliance and enables implementation of decisions. These services are purely analytical, however, and are not intended as a substitute for a portfolio manager’s expertise in making decisions. The services were described as services which might otherwise be carried out by assistants to fund managers or might otherwise be purchased in.

It happens that most of the BlackRock VAT-group clients are non-SIFs, but Aladdin can support both types of funds.

Exemption issue

Following *Abbey National plc v Commissioners of Customs & Excise (C-169/04)*, for the VAT exemption for the management of SIFs to apply it is necessary that:

“the services performed by a third-party manager in respect of the administrative management of the funds must, viewed broadly, form a distinct whole, fulfilling in effect the specific essential ... elements of the management of special investment funds. Mere material or technical supplies, such as the making available of a system of information technology, are not covered by [the exemption]”.

Other points arising from case law are that:

- the exemption is defined by the nature of the services provided and not according to the person supplying or receiving the services;
- it applies not only to investment management involving selection and disposal of assets under management but also to administration and accounting services;
- services within the exemption generally track those set out in the UCITS Directive, although this is not an exhaustive list; and
- in principle, it is fine to break the management of SIFs into a number of separate services.

The First-tier Tribunal was clear that the Aladdin services were “specific” to, and intrinsically connected with, the BlackRock group’s businesses as fund managers. The services were also “essential” as they could not easily or practicably have been carried out manually, and they did not fall within the disqualification for systems of information technology, which prohibits exemption only for the supply of generic IT systems that are common to many businesses.

Finally, the First-tier Tribunal also considered that the Aladdin services met the requirement that they form a “distinct whole”, being distinct from the activities carried on by the BlackRock companies. This conclusion was not affected by the fact that it was the BlackRock employees operating the platform.

Apportionment issue

The supply was accepted to be a single composite supply of management services to the BlackRock VAT group as a whole which would, under normal *Card Protection Plan*² principles, be subject to a single VAT rate – here, the standard rate. However, BlackRock argued that the supply should be split between the onward supplies to SIFs and those to non-SIFs so that the input tax relating to onward supplies to SIFs could be exempt.

While there is precedent allowing for multiple rates within a single composite supply (notably, the *French Undertakers (C-94/09)* case), the circumstances where multiple rates can be used are extremely narrow and rely on there being clear authority in the legislation. The First-tier Tribunal here had no difficulty in stating that this supply should be taxed at a single standard rate.

VAT treatment of pension fund management services – RCB 03/17

As from 1 January 2018, HMRC is discontinuing its policy of allowing insurers to treat their supplies of pension fund management services as VAT exempt insurance.

HMRC has historically allowed all pension fund management services provided by regulated insurance companies to be exempt from VAT. Following the *Card Protection Plan Ltd v Commissioners of Customs & Excise (C-349/96)* decision, UK law was amended from 1 Jan 2005 to remove any link between an insurer’s regulatory status and the entitlement to VAT exemption on its supplies. HMRC continued to grant an exemption for supplies of pension fund management services in the light of the continuing evolution of case law in respect of the application of the VAT exemption for the management of SIFs to pension funds.

In *ATP Pension Services (C-464/12)*, the CJEU found that a pension fund which pooled investments from a number of defined contribution occupational pension schemes qualified as a SIF for the purposes of the VAT exemption for fund management services. Conversely, services supplied in connection with defined benefit pensions schemes were found by the CJEU in *Wheels Common Investment Fund Trustees (C-424/11)* to fall outside this fund management exemption.

HMRC now considers this case law position to be sufficiently settled and so has withdrawn the insurance exemption for anything other than the underwriting of risk.

This means that, while insurers providing pension fund management services in respect of SIFs (i.e. those funds which meet the criteria set out in the *ATP Pension Services (C-464/12)* decision) will benefit from the SIF VAT exemption, insurers must now charge VAT when making a supply to non-SIFs of pension fund management services.

The HMRC briefing on the decision may be found at the following web address: <https://www.gov.uk/government/publications/revenue-and-customs-brief-3-2017-vat-treatment-of-pension-fund-management-services/revenue-and-customs-brief-3-2017-vat-treatment-of-pension-fund-management-services>.

Conclusions

With increasing numbers of bespoke IT systems for fund management, the guidance given by the First-tier Tribunal in *BlackRock* will be welcomed, particularly with regard to what services can be viewed as a “distinct whole”.

However, both of these developments raise difficulties for composite supplies of fund management services. To obtain the benefits of the exemption, it is clear that the composite supply needs to be to SIFs rather than predominantly non-SIFs. The combined effect of the HMRC decision and the *ATP Pension Services (C-464/12)* and *Wheels Common Investment Fund Trustees (C-424/11)* cases is to expand the range of scenarios in which this may be an issue by creating a disparity in the VAT treatment of management services provided to defined benefit and defined contribution pension schemes.

Fund managers making supplies to both types of pension funds will therefore need to consider whether it would be feasible to have entirely separate supplies where they provide services to both defined benefit and defined contribution pension schemes. This is likely to be challenging, assuming that the funds will be investing in the same types of securities, but whether this is feasible will depend also on the services provided to the managers. If a split approach is taken, managers will need to be careful to ensure that such arrangements reflect the economic substance of the supply relationship and do not appear to be contrived or artificial otherwise the VAT abuse principle as set out in *Halifax plc v Commissioners of Customs & Excise (C-255/02)* may be applicable.

² *Card Protection Plan Ltd v Commissioners of Customs & Excise (C-349/96)*



UK

As rebrands go, SIMR to SM&CR sounds simple; but there is a catch for insurers

By Lorraine Johnston, UK

Insurers could be forgiven for feeling left out when on 26 July 2017 the FCA announced the anticipated extension of the Senior Managers & Certification Regime (SM&CR) rules, which currently cover banks and PRA-authorised investment firms, to all FCA-authorised firms. On the same day, the PRA and the FCA also published two related consultations (CP14/17 and CP17/26 respectively) which contained proposals to extend SM&CR to insurers, but this was barely mentioned. This is likely because the aim of the proposed extension of the SM&CR rules to insurers, is to align, rather than introduce, the current governance requirements for insurers, which are a mix of PRA's Senior Managers Regime (SIMR) and the FCA's Approved Persons Regime, with those in place for banks and PRA investment firms.

Background

From Q1 2016, the PRA's rules on SIMR have applied to Solvency II insurers, large insurance special purpose vehicles (ISPVs) and large non-directive firms (NDFs), being insurance firms that are not Solvency II firms but which have assets relating to regulated activities of more than £25m. SIMR is the PRA's rules

for the governance of insurers, but the FCA's Approved Persons Regime has also continued to apply, with some modifications.

SIMR does not contain some of the key elements of SM&CR, such as the duty of responsibility or the certification part of SM&CR. This is one of the reasons why SM&CR is being extended.

Similarly, some parts of the FCA's Approved Persons Regime apply in relation to significant influence function holders for Solvency II firms.

CP14/17 and CP17/26 bring the governance requirements for insurance firms into line with the SM&CR rules and in particular they propose that:

- a. the FCA's Approved Persons Regime will be replaced by an insurance version of SM&CR; and
- b. the PRA's rules on SIMR will be amended to look and feel much more like the SM&CR rules for banks.



Three main pillars of the SM&CR/SIMR rules – current position

Senior Managers Regime:

For banks: The rules for Senior Managers cover certain individuals who perform senior management functions and who are subject to approval by the regulator. Senior Managers must have a statement of responsibility and the firm must have a management responsibilities map. Senior Managers are under a duty of responsibility which allows the FCA or the PRA to take enforcement action against a senior manager. This is where a manager is responsible for the management of any activities in the firm in relation to which the firm contravenes a regulatory requirement and such person had not taken steps that a person in their position could reasonably be expected to take to avoid the contravention occurring or continuing.

For insurers: Under SIMR, the PRA has set out a small number of senior insurance management functions (SIMFs). Individuals who perform these functions need to seek and obtain approval from the PRA, and the FCA

must also give its consent. All insurers (with some limited exceptions) are required to have the following SIMFs:

- a. Chief Executive function (SIMF1);
- b. Chief Finance function (SIMF2); and
- c. Chairman (SIMF9).

In addition, insurers may have chief risk officers, heads of internal audit, a chief actuary, chief underwriting officers, and a person performing underwriting risk oversight, if appropriate. The PRA applies a principle of proportionality. Solvency II firms and large NDFs have more onerous requirements. Like for the SM&CR, prescribed responsibilities set out by the PRA must be assigned to Senior Managers, such as the responsibility for ensuring obligations in the PRA Rulebook on fitness and propriety and maintenance of the firm's capital and liquidity.

Like the SM&CR, there are requirements under the SIMR for governance maps which accurately describe a

firm's governance arrangements and must be updated at least quarterly. Insurers must also prepare a scope of responsibilities for each Senior Manager, which is the equivalent of the statement of responsibility for banks and PRA investment firms. These scope of responsibilities forms must be clear, succinct and show the responsibilities that each individual is performing.

Certification Regime:

For banks: The SM&CR requires firms to assess the fitness and propriety of certain employees who, by virtue of their role, could pose a risk of significant harm to the firm or any of its customers. This moves the onus from the regulator to firms themselves to conduct the fitness and propriety checks on individuals performing Certification Functions (as well as for Senior Managers and NEDs).

For insurers: This part of the banking regime is not included in the SIMR. However, there are some analogous requirements from the PRA that Solvency II firms must ensure that all persons who perform "key functions" are fit and proper. Key function holders are those who are not SIMF holders or FCA significant influence function holders, but who discharge a key function. Key functions include risk management, compliance, internal audit and actuarial functions.



Conduct Rules:

For banks: These rules relate to professional conduct rather than conduct of business. For the SM&CR, they apply not only to those individuals caught by both the Senior Managers rules and the Certification Regime but also to all of a firm's employees other than ancillary staff. This excludes only a very narrow group of people such as cleaners, caterers, security guards, among others. There is also a requirement on the firm to report any breaches of these rules to the regulator.

For insurers: The PRA has almost identical rules for insurance firms under SIMR, with the exception that two of the conduct standards for banking firms do not apply and there is an additional standard for Senior Managers to consider the "interests of current and potential future policy holders in ensuring the provision by the firm of an appropriate degree of protection for their insured benefits" (reflecting the PRA's responsibilities under FSMA). The FCA has equivalent conduct standards, based on banking Conduct Rules. However the population of individuals subject to these rules is not as large as for the banking regime.

Key changes

The proposals set out in CP14/17 and CP17/26 will conform the SM&CR for the insurance and banking sector. There is some proportionality in the SM&CR to apply to insurers: Solvency II firms and large NDFs will be subject to more of the SM&CR rules than smaller NDFs who will be subject to a SM&CR-lite version.

To achieve conformity, a number of changes are proposed:

- a. SIMFs will be renamed as SMFs for consistency with the SM&CR, and the FCA is proposing a new set of SMFs that will replace its significant influence functions (SIFs) for insurers.
- b. Insurers will need to allocate additional FCA and PRA prescribed responsibilities to their Senior Managers.
- c. Senior Managers within insurers will be subject to the statutory duty of responsibility described above.
- d. Governance maps will be changed to management responsibility maps and the "scope of responsibilities" document will be changed to statements of responsibility.
- e. Solvency II firms and large NDFs will need to comply with a new handover requirement (to which banks are already subject) for Senior Managers.



The most important change is that insurers will now be subject to a Certification Regime type requirement and will need to satisfy themselves that certain employees within the certification regime are fit and proper. This must be assessed every year and a certificate issued to the individual by the firm.

Again a proportionate approach has been taken between Solvency II insurers, ISPVs, large NDFs on the one hand and small NDFs on the other. The PRA has stated that it aims to align the Certification Regime population as closely as possible with the population identified for the purpose of the firm's remuneration policy. What was referred to as "key function holders" will be designated as certified persons. For large Solvency II firms and large NDFs, material risk takers would also be designated as Certified persons. Regulatory references would be required to be sought for individuals in these roles.

Next steps

In Q4 2017, the PRA is expected to publish a further consultation paper on proposals to align some of the terminology more closely with the SM&CR and to update the forms that enable the application of the SM&CR to both the insurance and banking sectors. The paper may also

include proposals for relevant transitional measures for the commencement of the new regime. In Q4 2017, the FCA is expected to consult on operational aspects of the extended SM&CR, including how firms will transition into the regime, and any changes it will need to make to its forms and other parts of its Handbook.

The closing date for responses to CP17/26 and CP14/17 was 3 November 2017 and HM Treasury is expected to make a commencement order to bring into force provisions of the Bank of England and Financial Services Act 2016 that extend the SM&CR to insurers early next year. It is expected that these changes will take effect in late 2018.

The future

It is hoped that these changes will mean a more coherent system of governance requirements for insurers and more alignment with the rules already in place for banks and PRA investment firms. While this may make it easier for regulators in the long run, it means that insurers will need to undergo more changes to their governance arrangements, only two years after the last major overhaul. This is burdensome for an industry that has only just got to grips with the SIMR.

Non-consumer disclosure reforms in the United Kingdom and Australia

By Rehana Box and Marie Vlassis, Australia



Part I: the concepts of “disclosure”, “misrepresentation” and the abrogated concept of “fair presentation”

Insurance law reform in the UK has been on the parliamentary agenda for over 50 years, involving various consultations, proposals and reports, despite decades of resistance by the insurance industry. Notwithstanding industry resistance, the Insurance Act 2015 (UK) (IA UK) was enacted, coming into effect on 12 August 2016 (as discussed in [the Global Insurance Focus – Issue 5](#)).

In Australia, parallel developments have occurred, over a more extended period since the enactment of the Insurance Contracts Act (1984) (Cth) (ICA), which effected major changes in the common law, with a vision to modernise the practice of insurance.

In this article we compare the Australian concepts of “disclosure” and “misrepresentation” with the abrogated UK concept of “fair representation”.

Later articles in this series will cover knowledge of the insured, remedies and future Australian reform.

The “Anglo-Australian” Disclosure Regime

For present purposes, it is important to understand the “Anglo-Australian Disclosure Regime”.¹ This encompasses:

- a. the common law duty of disclosure, which was codified in the Marine Insurance Act 1906 (UK)² (MIA 1906);
- b. the common law that remains in force for marine insurance in Australia, codified in the Marine Insurance Act 1909 (Cth)³ (MIA 1909) (replicating the repealed UK sections);
- c. the common law duty of disclosure that applies to reinsurance contracts in Australia;
- d. the Australian non-marine regime, set out in the ICA; and
- e. the IA UK which abrogates the common law and extends to all forms of insurance, including marine insurance and reinsurance (repealing MIA 1906).⁴

¹ Rob Merkin, “What does an assured “know” for the purpose of pre-contractual disclosure?” (2016) *Insurance Law Journal* 157, 158.

² See sections 18 and 19 of the MIA 1906 which have been repealed by the IA UK.

³ Sections 24 and 25 of the MIA 1909.

⁴ Rob Merkin, “What does an assured “know” for the purpose of pre-contractual disclosure?” (2016) *Insurance Law Journal* 157, 158.



The Australian approach

Separate duties of non-disclosure and misrepresentation

In Australia, non-disclosure (section 21 of the ICA) and misrepresentation (section 26 of the ICA) are kept as distinct duties. However, it has been commented that they are “two sides of the same coin”. This sentiment is echoed by UK common law decisions, where generally the concepts are pleaded together. While being kept as separate duties, the same remedies apply to a breach of these duties (section 28 of the ICA).

Abolition of the “prudent insurer” test

The ICA dramatically altered the law on misrepresentation, in particular, by abolishing the long-established requirement that insurers must prove that the judgement of a prudent insurer would have been affected by the misrepresentation and, instead, replacing it with a “prudent insured” test. Over the last two decades of the ICA’s operation, this test has proven to better balance the interests of insurers and insureds.

The Australian regime is a Code

Part IV of the ICA is a statutory code that replaces the common law. The High Court of Australia⁵ confirmed that the circumstances in which it is legitimate to resort to the preceding common law, for the purpose of interpreting statute, are extremely limited. Decisions in the proceeding decades have upheld the High Court’s approach.

It is important to note that the ICA applies to both general and life insurance, but carves out marine and reinsurance, unlike the IA UK, which extends to most classes of insurance.

The UK’s approach to reform

A single duty of “fair presentation”

The English common law position on disclosure has been described as being poorly understood, which led to widespread failure to provide material information.⁶ In light of these shortcomings, the IA UK repealed sections 18 to 20 of the MIA 1906 and so dispensed with the duty of utmost good faith in the context of the insured’s pre-contractual duties, and replaced it with the concept of “fair presentation”.⁷

⁵ Advance (NSW) Insurance Agencies Pty Ltd -v- Matthews [1989] HCA 22.

⁶ English Law Commission and Scottish Law Commission, “Insurance Contract Law, Issues Paper no 1 – “Misrepresentation and Non-Disclosure”, September (2006), 44, [5.8] to [5.10].

⁷ Rob Merkin and Ozlem Gürses, “The Insurance Act 2015: Rebalancing the Interests of Insurer and Assured” (2015) The Modern Law Review Limited (78) (6), 1004, 1009.

Section 3 of the IA UK repackages the insureds' duty to disclose as a duty of fair presentation of risk.⁸ Under the IA UK, the duty of fair presentation encompasses the common law elements of non-disclosure and misrepresentation; this is largely because misrepresentation and non-disclosure are often pleaded and considered together.⁹ Professor Robert Merkin states the law of non-disclosure has tended to dominate, with little attention being given to misrepresentation in an insurance context.¹⁰

The reform is significant because the IA UK provides illustrations of the classes of fact that are likely to be material. This includes special or unusual facts relating to the risks and/or any particular concerns which led to seeking insurance cover for the risk.¹¹

The “prudent insurer” test

The IA UK imposes a requirement on the policyholder to disclose “every material circumstance” which might be relevant to an insurer. Despite recommendations, the “prudent assured test”, as adopted in Australia, and long mooted in the UK as a fairer approach to disclosure, has not been adopted.¹²

The UK's retention of the common law, and reluctance to adopt the balanced Australian approach of the “reasonable insured” test, is possibly due to the fact that they may introduce an untested concept into the law. In turn, this would take judges time to develop the law and make it difficult to advise businesses on what they should be expected to disclose.¹³

The IA UK is a default regime

Unlike its Australian counterpart, the IA UK is a default regime for non-consumer insureds. This provides insurers with the option to contract out of the disclosure obligations under the IA UK. The insurance industry was reluctant to adopt change in the UK, and it is apparent that the reform did not go as far as Australia, due to the fear of disrupting the industry. Some commentators¹⁴ are of the view that



the regime will be contracted out where the risk insured is unique or complex. Therefore, the IA UK is likely to be contracted out for many reinsurance contracts. Where an insurer wishes to contract on different terms, and a term is “disadvantageous” to the insured, the insurer must:

- a. take sufficient steps to bring the term to the insured's attention; and
- b. ensure that the term is clear and unambiguous.

This is a deliberately flexible test. For example, what is sufficient in a sophisticated market with well informed and advised parties, will not be adequate if the insured is a small business buying cover online.¹⁵

Concluding remarks

The UK has, like Australia before it, embarked on monumental reforms. The ICA, given its time in place has proven to strike a fair balance between insureds and insurers. This is largely a result of the consumer-driven nature of the insurance market in Australia. The IA UK is untested, and as yet, an uncertain model. While the ICA has introduced positive changes by codifying the disclosure regime and abolishing the prudent insurer test, it is important to note that it is only applicable to general and life insurance contracts. The MIA 1909 remains unchanged, mirroring the MIA 1906, and therefore the disclosure obligations for marine insurance remain outdated and out of touch in Australia.

Given the broad, albeit optional application of the IA UK, it may be time for Australian legislators to reconsider whether it is necessary to retain an entirely separate regime for marine and reinsurance contracts outside the ICA.

⁸ Section 3(1) of the IA UK.

⁹ English Law Commission and Scottish Law Commission, “Insurance Contract Law, Issues Paper no 1 – “Misrepresentation and Non-Disclosure”, September (2006), 44, 7, [2.13].

¹⁰ English Law Commission and Scottish Law Commission, “Insurance Contract Law, Issues Paper no 1 – “Misrepresentation and Non-Disclosure”, September (2006), 44, 7, [2.13].

¹¹ Rob Merkin and Ozlem Gürses, “The Insurance Act 2015: Rebalancing the Interests of Insurer and Assured” (2015) *The Modern Law Review Limited* (78) (6), 1004, 1011.

¹² Rob Merkin, “What does an assured “know” for the purpose of pre-contractual disclosure?” (2016) *Insurance Law Journal* 157, 164.

¹³ English Law Commission and Scottish Law Commission, “Insurance Contract Law, Issues Paper no 1 – “Misrepresentation and Non-Disclosure”, September (2006), 55, [5.47] and [5.48].

¹⁴ David Hertzell, “Reforms to UK insurance law: overview of key changes, Practical Law UK Articles 6-615-6445”.

¹⁵ David Hertzell, “Reforms to UK insurance law: overview of key changes, Practical Law UK Articles 6-615-6445”.

New restrictions on enforcing ipso facto clauses under insurance contracts

By Rehana Box, Australia

The reforms do not make “ipso facto” clauses in insurance contracts unlawful but they will not always be enforceable.

In the context of insolvency, “ipso facto” clauses are contractual rights that allow a counterparty to terminate or amend a contract merely because a company has suffered an insolvency event. In insurance contracts these clauses are sometimes referred to as “Special Termination Rights”. They are also sometimes included in conjunction with clauses allowing termination where the insurer’s financial strength rating has fallen below a minimum required level. Such clauses may create a right for an insured to terminate the insurance contract if the insurer becomes insolvent or is placed into liquidation or receivership.

As part of the Government’s National Innovation and Science Agenda these clauses were reviewed and on 12 September 2017 reforms were passed to protect corporations in financial difficulties by making “ipso facto” clauses unenforceable during certain formal insolvency processes.

Reforms

The Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 (Cth) (Act) will amend the Corporations Act 2001 (Cth) and introduce a “stay” on enforcing contractual rights that arise by reason of certain insolvency events.

The insolvency events that will trigger a “stay period” include:

Scheme of Arrangement:

A “body” publicly announces that it will apply for and, in fact applies for or enters into, a scheme of arrangement (but only where the company’s application to commence the scheme states that it is being made to avoid being wound up in insolvency).

Receivership:

A receiver or other managing controller of the whole or substantially the whole of a “corporation’s” property is appointed or exists.

Administration:

A “company” enters into voluntary administration.

The “stay” will not apply:

- a. To agreements made after the commencement of a scheme, receivership or other managing controllership or voluntary administration;
- b. To companies that are in liquidation (unless it was in voluntary administration before being liquidated) or engaged in insolvent trading;
- c. If the liquidator, administrator or person appointed to administer a scheme of arrangement has consented in writing to the enforcement of the right;
- d. To rights to terminate for other reasons (e.g. for convenience); and
- e. To rights prescribed by the regulations or declared in a Ministerial determination.

The changes commence on 1 July 2018. However the Governor-General may announce an earlier commencement date. The changes will only apply to contracts made after the Act comes into force. Therefore, any rights linked to insolvency events that are included in existing contracts may still be able to be enforced despite the changes made under the Act.

Impact of the reforms

The reforms do not make “ipso facto” clauses in insurance contracts unlawful but they will not always be enforceable. Some parts of “ipso facto” clauses may not be impacted if they provide rights of termination not dependent on the prescribed insolvency events.

Unless regulations are made to exclude rights to terminate insurance contracts from the operation of these amendments, an insured will no longer be able to enforce a right to terminate a contract of insurance merely because the insurer commences a scheme, receivership or other managing controllership or voluntary administration.

An insured who seeks to exercise a right to terminate that is “unenforceable” may be found to have wrongly repudiated the contract (given it had no enforceable right to terminate) and subsequently be liable for damages.

Insureds should:

- a. Be proactive when placing or renewing insurance policies and carefully consider financial strength ratings.



- b. Seek legal advice before exercising contractual rights (particularly rights to terminate) on the basis of an actual or possible insolvency event.
- c. Consider seeking to include a right to terminate for convenience in their insurance contracts.

Insurers should:

Consider the terms of such clauses in their policies. While not unlawful, such clauses could be misleading as to the insured’s right to terminate.

Brokers should:

- a. Ensure that insureds understand whether such rights in insurance contracts are in fact enforceable.
- b. Consider including rights for the insured to terminate for convenience.
- c. Advise insureds not to seek to exercise such contractual rights without first obtaining legal advice.

Our “Commonwealth Alert” titled “Contractual rights to terminate for insolvency may be unenforceable”, dated 19 September 2017 also discusses the implications of the changes.



ASIA

China cybersecurity law

By Daniel Öhvall, Asia

China is at the forefront of fintech and digitalisation, and the insurance industry is no exception. Until recently, the rules and regulations relating to personal data and network security were relatively loose and scattered. This changed when the Cybersecurity Law (CSL) came into effect on 1 June 2017 giving wide-ranging powers to a new and well-resourced regulator – the Cybersecurity Administration of China (CAC) – which will work with sector-specific regulators, such as the China Insurance Regulatory Commission (CIRC). Insurers in China are in the process of reviewing their existing operations to navigate the new regulatory environment.

CSL's scope is broad and includes, among other things, obligations on businesses to improve network security and IT systems generally, co-operate with government agencies in the national and public interest, obtain customer consent for collecting personal data and places restrictions on the storing and transferring of data. It is followed by other rules and guidance which will determine many of CSL's practical implications. In this article we look at two important aspects for insurers in China.

Localisation and cross boarder transfer of data etc

CSL contains particularly onerous obligations in relation to Critical Information Infrastructure (CII), a term which covers “critical industries and fields like public communications and information services, power, traffic, water, finance, public service, electronic governance ... and other critical information infrastructure ... which if [lost, damaged or compromised] ... will result in serious damage to the national security”. The CSL definition is broad and additional guidance and decisions are expected to clarify what will constitute CII and who will be classified as CII operators. However, CII may well include insurance operations handling substantial amounts of Chinese customer data.

Of particular importance to foreign-owned insurers is the requirement that CII operators must store locally all the personal information and important data gathered and produced in China. This requirement may force CII operators to use servers in China and to segregate their Chinese data from global databases.



Cross-border transfer of personal data will also be regulated. According to a draft of the relevant implementing rules, the new regime will come into effect on 31 December 2018 and broadly provides that (i) customers' consent must be obtained for cross-border transfers and (ii) large cross-border transfers of personal data or particularly sensitive information require prior regulatory approval whereas other cross-border transfers will be subject to self-assessment.

Collection and use of customer data

CSL contains measures to protect customers' personal data. When collecting personal data, the network operator must obtain the data subject's consent and disclose the purposes, means and scope of the collection and use of the personal data. Further, the personal data must be kept secure and not be used for unrelated purposes. Individuals also have a right to request network operators to delete their personal information and to make corrections to it.

Conclusion

These legislative provisions are new and the CSL contains no express grandfathering provisions. Insurers should reassess customer onboarding procedures and IT and administrative processes and decide whether customer consents obtained in the past are sufficient.

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