UNIVERSITY OF THE WITSWATERSRAND, JOHANNESBURG

FACULTY OF COMMERCE LAW AND MANAGEMENT

A HISTORICAL ANALYSIS OF THE ORIGINS, DEVELOPMENT AND NATURE OF MARKET CONDUCT REGULATION: A STUDY OF FOUR INSURANCE MARKETS

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Course Code: CR000

Degree: Master of Commerce (Insurance and Risk Management)

School: Economics and Business Sciences

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A dissertation submitted to the Faculty of Commerce, Law and Management of the University of the Witwatersrand, Johannesburg, in fulfilment of the degree Master of Commerce (Insurance and Risk Management) by dissertation.

June 2017

DECLARATION

I, ……...declare that this research report is my own, unaided work, the substance of or any part of which has not been submitted in the past or will be submitted in the future for a degree in any university and that the information contained herein has not been obtained during my employment or working under the aegis of, any other person or organisation other than this university.

_____ _____

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Signed this _____ day of _____ 2017 at Johannesburg.

ACKNOWLEDGEMENTS

Firstly, I would like to express my sincere gratitude to my supervisor, Professor Robert Vivian, for the continuous support of my Masters study. Thank you for your unwavering patience, guidance, motivation, and instrumental knowledge. Your invaluable mentorship has been reassuring throughout this process.

I would also like to thank all of my other colleagues for their insightful comments and encouragement. Thank you for constantly giving me the drive to complete my studies.

To my family, friends and wonderful fiancé, Brent, thank you for lending an ear and providing the love and support throughout my Master's journey.

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ABSTRACT

In 2011, National Treasury proposed the introduction of the Twin Peaks regulatory model for the South African financial sector. The adoption of this model will significantly change the regulatory landscape in South Africa. A growing body of mainly government generated literature focuses predominantly on the introduction of the Twin Peaks regulatory model and concentrates on the structure of this model rather than on the details of the model's two peaks: prudential and market conduct. Market conduct regulation is understood in broad terms, however only limited studies are available as to the details of this peak. The study provides discourse as to the history and the role of the state (with specific reference to the Lockean framework) and further examines the various economic theories of regulation which provide the justifications for regulation. A brief discussion of the Twin Peaks system provides the necessary background and contextualisation. The purpose of this study is to establish the origins, development and nature of market conduct regulation in four insurance markets, including the United Kingdom (UK), European Union (EU), United States (US) and South Africa, with specific reference to the South African short term insurance market. This is achieved by providing a narrative of the development of insurance regulation in the four markets. From this narrative, the development of market conduct regulation is specifically distilled and the applicability of the various economic theories of regulation is sporadically assessed. The findings indicate that traces of market conduct issues can be detected at various periods in the nearly 500 year history of the global insurance market. However contemporary market conduct regulation evolved in the mid-1900s in the US and between 1986 and 2000 in the UK. In this regard, market conduct regulation was pioneered in these two markets. Furthermore, the study argues that contemporary regulatory developments in the UK have seen the market gradually transition away from regulation that historically was underpinned by the Lockean framework to a new framework. The study does not define or critiqued this new framework. This may be an avenue for further and more focused research.

Keywords: development, European Union, history, insurance, market conduct regulation, origins, regulation, South Africa, Twin Peaks, United Kingdom, United States.

RESEARCH OBJECTIVES

The study discusses the history and the role of the state with reference to the Lockean framework and further examines the various economic theories of regulation which are often cited as a rationale for regulation. A brief discussion of the Twin Peaks system (including prudential regulation and market conduct regulation) is necessary in order to place the proceeding discussions into context. These early discussions lay the foundations from which the primary research objectives are achieved. The objectives of this research are to establish the origins, development and nature of market conduct regulation in four pre-selected insurance markets. In doing so, this study adds to the limited body of knowledge on the subject matter at hand.

This dissertation is divided into three parts. The first part seeks to plot a history of insurance regulation in the United Kingdom, European Union, Unites States and South Africa. The famous English historian, Edward Hallett Carr (1961), pointed out that there is no single history. Histories are written for a purpose. In this case, the history is written to discover the origins, development and nature of market conduct regulation. The history set out in this study will be, of necessity, unique.

The first part sets the scene for the second. In terms of the second phase in the research, the dissertation details the development of market conduct regulation in these markets. This facilitates the identification of the origins of market conduct regulation. The third part of this research determines the nature of market conduct regulation with specific reference to the British insurance market. The Lockean framework is taken as the benchmark in order to perform this evaluation. The research evaluates if market conduct aspects during a particular period, fit into the Lockean model. There is a fourth, albeit secondary, dimension to this research. In terms of this final part, the dissertation sporadically evaluates the applicability of two central theories of regulation to various historical periods that are reviewed in the study.

METHODOLOGY

The methodology which is to be applied to achieve the research objectives noted above is as follows:

i. The thesis sets out a detailed historical account of the regulatory systems in four insurance markets, namely the United Kingdom, European Union, Unites States and South Africa;

ii. In each period, the history is examined in order to isolate market conduct aspects (the origins of market conduct regulation can then be identified);

iii. As an interlude, various historical periods are examined in order to determine the nature of market conduct regulation in that period;

iv. As an interlude, various periods are examined in order to discuss the applicability of economic theories of regulation during that period.

There is a large body of literature which documents various regulatory systems and developments in isolation. The research therefore compiles and consolidates existing literature in order to provide a comprehensive overview of the history of insurance market regulation in the four pre-selected markets. In doing so, the research is able to distil and plot the development of market conduct regulation in the aforementioned four markets and further lays the foundations for the concluding parts of the study. In view of this, a historical approach is justifiable.

In addition to existing literature, the study relies on various Acts of Parliament, Hansard Parliamentary debates, Commission reports, government reports and case law in order to construct a thorough historical outline and assessment.

1. INTRODUCTION

Following the recent global financial crisis, the regulation of financial markets has received renewed attention and focus. As such, the imposition, monitoring and enforcement of rules and standards of best practice have become far more acute. In February 2011, National Treasury published a policy document entitled "A safer financial sector to serve South Africa better" in terms of which Treasury announced the proposed introduction of the Twin Peaks regulatory model for South Africa. In doing so, National Treasury is following the lead given earlier by the United Kingdom's government which announced that it was abandoning the discredited single regulator model that had been introduced in 2000, in favour of the Twin Peaks model. The implementation of this regulatory model will likely be the impetus for regulatory reform of the South African financial services landscape. The Twin Peaks model has therefore become relevant and topical.

In terms of this model, the two regulatory peaks include prudential regulation and market conduct regulation, each of which has a designated regulator. There is a growing body of mainly government generated literature which focuses predominantly on the introduction of the Twin Peaks. However, most of this literature concentrates on the structure of the model rather than on the details of the peaks. This is not a problem in terms of prudential regulation since a large amount of literature can be found which exclusively discusses this peak. This is owing to the fact that prudential regulation has existed since 1870, following the passing of the British Life Assurance Act and accordingly, this has been subject to over a century's worth of research.

On the other hand, literature, and again, predominantly government reports, focuses primarily on the structure of market conduct regulation in terms of the Twin Peaks model. As such, from the existing literature, what is meant by market conduct is understood in broad terms. However, limited studies are available which document the details of market conduct regulation. Accordingly, the first peak, prudential regulation, is well-known but what the second peak, market conduct, entails is less clear.

It therefore follows that the research problem at hand is the absence of similar studies to the one proposed in this research proposal and consequently, the absence of knowledge regarding the origins, development and nature of market conduct regulation. Since the proposed introduction of the Twin Peaks system, an understanding of market conduct regulation has

become particularly relevant and newsworthy. Accordingly, research is necessary in order to add to the limited body of knowledge on the subject matter at hand.

The thesis therefore provides greater clarity as to what the second peak encompasses. In view of that, the purpose of the research is to establish the origins, development and nature of market conduct regulation in four insurance markets, including the United Kingdom (UK), European Union (EU), United States (US) and South African, with specific reference to the South African short term insurance market.

The thesis is qualitative in nature and is underpinned by historical analysis, documentary analysis and descriptive design. The thesis traces the origins and development of market conduct regulation through the 500 year history of insurance regulation and does so in four parts. To begin with, the historical role of the state is discussed with specific reference to the Lockean framework. Since regulation is the focal point of this thesis, the latter is followed by a discussion of the various economic theories of regulation which attempt to explain the rationale for regulation. Thirdly, the focus then shifts to the Twin Peaks model and its intended implementation in the South African financial sector. This chapter provides a brief overview of prudential regulation and discusses market conduct regulation in greater depth. These early discussions provide the necessary context upon which proceeding discussions are based. It is in part four of the study that the main objectives are achieved.

The thesis then progresses to discuss the development of insurance regulation in the UK, EU, US and South Africa. In terms of this historical record and as an interlude, each historical period is examined further in order to isolate the market conduct aspects. In other words, the broader historical account of the regulatory systems is filtered further in order to trace the development of market conduct regulation in these markets. This is performed retrospectively. In doing so, the thesis is able to identify the origins of market conduct regulation - this is the main objective of the paper.

The next, albeit secondary, element of this research is to determine the nature of various market conduct regulatory developments. Since no other research has attempted to undertake such an assessment, determining the nature of various market conduct regulatory developments will be done sporadically where such an assessment is appropriate. From this, more general inferences and conclusions are drawn. Market conduct ostensibly has to do with consumer protection. It deals with the legal relationship between an institution and a

customer. Legally, this relationship historically has been governed almost exclusively by the law of contract. The law of contract itself has not been static but to the extent that this has developed, it has been on an incremental basis under the control of the judiciary. A number of consumer protection safeguards have evolved such as those dealing with unfair contract terms. Parliament has generally not found it necessary to intervene in the contractual relationship. As such, the rule of law (encompassing contract law and the due process of the law) historically has governed the relationship between the insurer and their consumers. These ideals were articulated by John Locke and accordingly the Lockean framework is taken as the benchmark in order to perform this phase of the research. The research therefore sporadically evaluates whether the market conduct aspects during a particular period fit into the Lockean model.

As noted above, since regulation and the development thereof is the primary focus of this study, an understanding of these historical developments ought to be aided by an assessment of the applicability of the economic theories of regulation to the respective market event at hand. This is a secondary dimension of the research. The economic theories of regulation are well-known. This phase of the research shall therefore evaluate the applicability of the theories of public interest and regulatory capture to the various historical periods that are under consideration. Again, this is done intermittently where such an evaluation is appropriate to undertake. Yet again, the absence of studies in this regard limits this aim to a secondary objective. The research will not attempt to assess the validity of these theories; the tenants that underpin these theories are accepted for purposes of this study.

It is anticipated that although traces of market conduct issues can be detected at various periods in the nearly 500 year history of the global insurance market, contemporary market conduct regulation evolved in the US during the 1980s as per the National Association of Insurance Commissioners' (NAIC) Constitution and in the UK between 1986 and 2000, following the establishment of the Financial Services Authority (FSA). The research findings also suggest that the development of market conduct regulation in the aforementioned four markets historically has been in response to various corporate failures and/or market scandals. In this view, market conduct regulation, traditionally, has been promulgated for the public interest in general, however, evidence of regulatory capture during these times is referred to.

More recent market conduct regulatory changes however have not been influenced by a particular market event. The research thus suggests that contemporary regulatory changes are supported by the theoretical tenets of regulatory capture and more specifically, what this research refers to as legislative capture. The research further demonstrates that historically the Lockean framework has been upheld and applied. However, since the birth of market conduct regulation in the late 20th century, a transition has begun to take place away from the Lockean framework to a new framework, although the new framework cannot at this point be defined, assessed or critiqued.

This research provides an original and theoretical contribution by establishing the origins, plotting the development and assessing the nature of market conduct regulation, specifically with reference to the Lockean framework since limited evidence can be located in this regard. This research thus provides a valuable contribution to National Treasury, policymakers, academics and all other interested parties in the countries included in this study.

PART I: THEORETICAL FRAMEWORKS FOR REGULATION

2 THE ROLE OF THE STATE

John Locke (1632-1704) produced the most well-known and enduring thesis on the function of government. He advanced a number of fundamental tenets of both political and natural rights philosophy. Such rhetoric can be found in three important works including: *A Letter Concerning Toleration* (1689), *An Essay Concerning Human Understanding* (1689) and *Two Treaties of Government* (1689). It is the latter work that is of particular significance to this research and as such, forms the point of departure with respect to understanding the role of the state in terms of regulation.

In Chapter II 'of the State of Nature', Locke (1689/2005) argues that in order to understand the role of government and political power in society, one ought to start at the beginning of the evolutionary process of society; man in nature without a formal form of government. In this state, Locke (1689/2005 as cited in Mack, 2013) holds that each individual possesses natural rights to life, liberty and property. These are not given; they are possessed. This view is echoed in the United States' Declaration of Independence (1776), in terms of which 'all men are endowed with unalienable rights; rights to life, liberty and the pursuit of happiness'. Locke (1689/2005) however accepts that such natural rights do not exist merely metaphysically. They can be infringed upon or trespassed against by others, just as soon as these other persons enter into the natural state of nature. These rights can be invaded by others and thus need protection. It is this idea that informs Locke's rationale for the existence of a political society and the need for a government. Locke (1690 para 123-126) asserts that:

> …though in the state of nature he hath such a right, yet the enjoyment of it is very uncertain, and constantly exposed to the invasion of others: for all being kings as much as he, every man his equal, and the greater part no strict observers of equity and justice, the enjoyment of the property he has in this state is very unsafe, very unsecure. This makes him [the person in a State of Nature] willing to quit a condition, which, however free, is full of fears and continual dangers: and it is not without reason, that he seeks out, and is willing to join in society with others, who are already united, or have a mind to unite, for the mutual preservation of their lives, liberties and estates, which I call by the general name, property. The great and chief end, therefore, of men's uniting into commonwealths, and putting themselves under government, is the preservation of their property. To which in the State of Nature there are many things wanting. *First*, There wants an established, settled, known law, received

> and allowed by common consent to be the standard of right and wrong, and the common measure to decide all controversies between them: for though the law of nature be plain and intelligible to all rational creatures; yet men being biased by their interest, as well as ignorant for want of study of it, are not apt to allow of it as a law binding to them in the application of it to their particular cases. *Secondly*, in the state of nature there wants a known and indifferent judge, with authority to determine all differences according to the established law: for everyone in that state being both judge and executioner of the law of nature, men being partial to themselves, passion and revenge is very apt to carry them too far, and with too much heat, in their own cases; as well as negligence, and unconcernedness, to make them too remiss in other men's. *Thirdly*, in the state of nature there often wants power to back and support the sentence when right, and to give it due execution. They who by any injustice offended, will seldom fail, where they are able, by force to make good their injustice; such resistance many times makes the punishment dangerous, and frequently destructive, to those who attempt it.

That is, Locke (1689/2005) argues that men are willing to give up a certain amount of autonomy and unite into commonwealths for the mutual preservation of their (natural) rights, i.e. their lives and property (Reekie, 1997). More specifically, humankind forfeits the absolute rights (within a state of nature) in return for the security that can be provided by a government since a state of nature lacks the ability to protect the very rights that it confers (Locke, 1689/2005; Bunnin & Yu, 2004). It therefore follows, that laws ought to exist or be passed for i) the protection of natural rights including life, liberty and property ii) from others and thus iii) such laws are for the public good, or as is nowadays said, in the public interest.

Locke (1690: para 3) summarised this position as follows:

> Political power, then, I take to be a right of making laws with penalties of death.' and consequently all less penalties, for the regulating and preserving of property, and of, employing the force of the community, in the execution of such laws, and in the defence of the commonwealth from foreign injury; and all this only for the public good.

The state of nature is unable to protect one's natural rights since it lacks i) established laws intended to protect rights (by prohibiting other persons from infringing on these rights); ii) an impartial judge with the authority to settle differences in an established court following the due process of law and; iii) a power to impose and enforce the appropriate remedy (Locke, 1689/2005). Accordingly, the function of government is to articulate and protect the life, liberty and property of an individual via the rule of law[1] and the due process of the law

[1] Former president Nelson Mandela (as cited in Louw, 2013) asserted that the rule of law refers to "a structural exercise of rule as opposed to the idiosyncratic will of kings and princes. Even where the latter may express

(Mack, 2013). This may be achieved through the establishment of a police force, prosecuting authority, judiciary, corrective services and in many cases, an army (Vivian, 2014). Thus within the Lockean framework, the role of the state is to protect natural rights via the rule of law. This does not include intervention within the economy. However, centuries after Locke detailed his ideas, there was pressure to expand the role of government beyond the Lockean framework. This was done particularly by socialist thinking, as developed further by Karl Marxs and Friedrich Engels, who together developed Marxism theory and who advocated the principles of communism.

Acceptance of state intervention received support from other sources. Economies were mobilised as they were placed on a War footing involving massive central planning (Saaler & Szpilman, 2011). Germany embarked on a programme of massive public works to counter unemployment which was followed by the US with its New Deal (Bendersky, 2007). These programmes received credibility through the ideas of English economist John Maynard Keynes (1883-1946) which contributed to the notion of state intervention in the economy.

Throughout the Great Depression (1929-1939) when unemployment was the order of the day, Keynes "inspired new thinking about how government intervention could promote recovery" by stimulating aggregate demand (Eckes, 2011:94). Keynes' theoretical contributions acknowledge governments' influence on national economies and further asserted that macroeconomic tools can be employed by government to control aggregate demand for labour and thus increase employment during those periods of recession (Eckes, 2011:94). Keynes therefore concluded that the establishment of a semi-autonomous state enterprise is ideal in order to resuscitate the economy when it is experiencing difficulty (McCann, 1998:9). Although the Great Depression seemed to indicate that government intervention could correct market shortcomings, it took some time before Keynes' case for government intervention in the economy became well established in economic theory (Barnett, 2013).

It therefore follows that regulation can be justified primarily in terms of the Lockean framework. That is, action can be taken, or more correctly, laws can be passed and applied to protect life and property. However, government action may be influenced also by broader

itself benevolently the former is morally and politically superior. Where the rule of law does not apply, rulers assume entitlement to rule; the rule of law, on the other hand, places the emphasis upon structured responsibility and obligation".

interventionist tendencies. The clear Lockean line has become blurred in recent times by other interventionist tendencies.

3 THEORIES OF REGULATION

A major challenge in economic and political science has been to explain government intervention, more often than not in the form of regulations in various markets. The focus of this investigation entails an understanding of what ought to be the intervention (or regulation) or why does the intervention or regulation exist. As such, for at least a half a century, commentators have been engaged in a debate as to what drives or explains the regulatory process. Various theories for regulation have emerged on the one hand to justify the existence of regulation and on the other hand to explain or provide a rationalisation for regulation, especially regulation of financial markets. Each theory or paradigm has its own strengths and weaknesses. The most relevant theories are, firstly, the public interest theory which can be used to justify the passing of regulations and, secondly, the capture theory which can be used to explain the existence of regulation. Some may argue that regulatory capture is but one of the economic theories of regulation giving a broader economic framework for regulation. A discussion of the theories of regulation is necessary to inform one's understanding of the potential influences on government intervention and regulation in a market.

3.1 Public interest theory

The oldest and most widely cited basis for the passing of regulation is public interest. Regulation is passed, so the argument goes, because the regulation is in the public interest. The concept of public interest is said to be as old as the political philosophy of government intervention and accordingly forms the point of departure (Hantke-Domas, 2003). [2] Having said that regulations are introduced because they are in the public interest, is not in and of itself useful, unless the meaning of public interest is also known. A wide range of views exist as to the meaning of 'in the public interest'. One view that is prevalent in economic literature, especially American literature, postulates that government's role is primarily to correct various market imperfections. The government is therefore a benevolent maximiser of social welfare, particularly when faced with a corporate failure (Posner, 1974; Laffont & Tirole, 1991). [3] More specifically, financial market activities (and, in particular, market

[2] In fact, the concept of public interest appears in the works of political philosophers such as Plato, Aristotle and Hobbes (Held, 1970 as cited in Hantke-Domas, 2003).

[3] Why this view is prevalent in American writing becomes clear when the American history is taken into consideration. Towards the end of the 1800s and extending into the early 1900s, American political thought was

failures) can often generate externalities that impose heavy social costs on society and which are generally not easily addressed by private agents (Botha & Makina, 2011). These market problems can, in turn, harm the public interest (Klein, 2005). As a result of this, regulatory bodies attempt to intervene to correct, lessen or eliminate these inefficiencies engineered by a market failure (Peltzman, Levine & Noll, 1989; Botha & Makina, 2011). A more extreme form of market failure within an insurance context occurred where consumers wished to purchase insurance but there were no suppliers. The Redlining problem in the US throughout the late twentieth century is one such example (Badain, 1980). The government intervention in this case was the introduction of Fair Access to Insurance Requirement (FAIR) Plans (Joskow, 1973). Another was the absence of medical health insurance to persons over the age of 65 (Akerlof, 1970). The government intervention in this case was the introduction of Medi-Care (Akerlof, 1970).

The statutory regulation of insurance companies has historically been rooted in public interest theory and accordingly, is an exercise to safeguard public interest (Adams & Tower, 1994). Insurance regulation has traditionally targeted the excessive risk of insolvency and more recently the market abuse of consumers (Klein, 2005). Solvency regulation of an insurance firm is underpinned by arguments of market inefficiencies and principal-agent problems (Munch & Smallwood, 1981). Accordingly, in the absence of such regulation, imperfect consumer information and principal-agent problems would cause a number of market problems which would consequently harm public interest (Klein, 2005).

In addition to this, insurance consumers often lack the mental models needed to understand the insurance market and further may possess inadequate information necessary to appreciate an insurance transaction (Botha & Makina, 2011). Consumers therefore may be vulnerable to abusive marketing and claims practices of insurers and agents (Klein, 2005). For this reason, it has been contended that regulation is required in order to correct these information imbalances or asymmetries where the insurer possesses greater information than the insured

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dominated by the Progressive Movement. America became obsessed with confronting big business; the railways, the oil business and the like. This culminated in the passing of legislation such as the Sherman Anti-Trust Act to be discussed in chapter 7 below. Big business was seen as evil. The free market, left to itself, created these evils and the duty of the state was to remedy these evils. Hence the dominant view of regulation was to correct market imperfections.

or where the industry purposefully suppresses the production of unfavourable information (Beaver, 1981).

Thus, regulators are said to have five main objectives when it comes to the statutory regulation of insurance companies (Meier, 1991: 701). These include:

i) To monitor corporate solvency

ii) To ensure fair trading

iii) To regulate entry into the market

iv) To promote price stability

v) To satisfy social objectives

3.2 Economic theory of regulation

3.2.1 Introduction

Economists began to examine regulation in terms of the application of economic theories to the regulatory phenomena. Under the heading of the economic theory of regulations, a number of specific theories have evolved, such as the theory of regulatory capture. Economic theory of regulation should thus not be seen as a separate explanation for the justification or existence of regulation but rather as the application of economic theory to explain these other observed phenomena.

Some have argued for limited regulation and government intervention on the basis that in the free market, markets are efficiently self-regulated by Adam Smith's invisible hand. It can be argued that the unregulated market is undermined by principal-agent problems in terms of which individuals, acting as agents, operate out of self-love and in their own self-interest. This ideal is reflected in Adam Smith's (1790/2007: 27) profound statement as seen in his work entitled *An Inquiry into the Nature and Causes on the Wealth of Nations* that:

> It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address

> ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantages.

When the agent works for his own interests and not his principal's, this can give rise to problems. This problem is compounded when agents propose laws which are claimed to be in the public interest. As Smith (1790/2007:267) warns, laws proposed in the public interest may not be in the public interest but rather in the interests of the proposers:

> The proposal of any new law or regulation of commerce which comes from this order [specific markets], ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

Numerous authors have suggested that regulations that are often proposed under the guise of 'public interest' may in fact be in the interest of some other group (Stigler, 1971). In short regulatory capture can take place. Levine and Forrence (1990:168) note that when regulators exercise public power in markets that allow individuals to make their own choices freely, naturally such governments need to find justification in their coercion. In many instances, justification is found in the so-called public interest to 'cure market failures', 'to protect the market from the evils of monopoly powers' or from 'destructive competition' but the real motives are intentionally disregarded. It therefore follows, that regulations proposed to be in the public interest are not necessarily always in the public interest. A factual examination is required to determine if the regulations are in the public interest even if they only indirectly serve the interests of the public in the form of consumers.[4]

In 1971, this line of thought received a boost when Stigler published his research which has had a lasting impact on the understanding of the economics of regulation. He introduced the

[4] In addition to this, two assumptions have historically typified the public interest theory. One assumption is that economic markets are extremely fragile and apt to operate very inefficiently (or inequitably) if left alone (Posner, 1974:336). The other assumption is that government regulation is virtually costless and therefore there is no need for a cost-to-benefit analysis (Posner, 1974). Evidence suggests however, the regulation is not costless. The cost of regulation is ultimately borne by the consumer as there is most certainly a cost of complying with the regulation. Furthermore, regulatory agencies themselves require remuneration. It therefore follows that regulation cannot be costless.

world to the concept of regulatory capture. Stigler (1971) suggested, after factually examining much of the regulation that existed in the US, that very little evidence exists showing that regulations are in fact passed in the public interest. When Stigler (1971) examined the empirical evidence, it pointed clearly to regulation being in the interest of the regulated industry. The regulated industry, so the argument goes, captured the regulator for its own interests.

3.2.2 Capture theory of regulation

That regulations were not being passed in the public interest was illustrated by earlier empirical research on regulation, as mentioned above. Stigler and Friedland's (1962) analysis of the effects of regulation on electricity rates which were supposed to lower electricity prices in the public interest, noted that restricting entry into the market and imposing maximum rates (in the 'public interest') had not resulted in lower electricity rates and were therefore contrary to public interest (Peltzman *et al*., 1989). A pattern of similar results continued to emerge during this time which empirically demonstrated that outcomes were incongruent to the public interest. In 1972, following Stigler's (1971) seminal work, William Jordan, after studying the plethora of literature on the effects of regulation, provided a summary of the new paradigm which had emerged therefrom (Peltzman *et al*., 1989). He concluded that the correct generalisation is that regulation serves the producer's interest (Peltzman *et al*., 1989). The capture theory of regulation thus began to emerge from empirical research into existing regulation.

The capture theory postulates that regulation is a "partisan political process conferring benefits on politically effective groups which capture and dominate the regulatory process" (Noll & Owen, 1983 and Reagan, 1987 as cited in Adams & Tower, 1994: 167). In other words, the regulatory process may be the outcome of opportunistic capture by groups who have an interest in the industry (Adams & Tower, 1994). A historical review reveals instances when laws have been passed, neither in response to an identified problem nor in the public interest, but rather for the benefit of a specific class of persons. Once again, Adam Smith's (1790) statement maintained the idea that individuals operate in their own self-interest, even when laws are proposed.

In general, it may well be the regulated industry itself which is dominant in capturing the regulator since they possess the economic resources, organisational capabilities and industry-

specific knowledge required to be a "politically effective group" (Ferox, 1987). Consumers seldom possess the attributes to become a "politically effective group". Accordingly, regulation is demanded by the industry and is designed and operated primarily for its benefit (Stigler, 1971: 3). Stigler (1971:5) suggests that among other things, industry players may seek to capture the regulator in order to (a) protect their market(s) from outside competition and the entry of new firms and; (b) to obtain state subsidies.

The capture theory however received its own criticism since like the public interest theory, it too was based on empirical findings and had no theoretical foundation (Peltzman *et al*., 1989). The economic theory of regulation therefore emerged to address the theoretical void that was characteristic of the capture theory.

In order to provide a rational explanation for the capture theory, Stigler (1971) later refined and extended the tenets of the capture theory into a reformulated theory of economic regulation[5] (Adams & Tower, 1994). In particular, Stigler (1971) approached the question of regulation from a perspective of economics. It had been suggested by Samuelson (1954) that the government can be viewed as a supplier of goods; public goods in this case. As such, regulation should be viewed as a public good which is subject to the economic laws of demand and supply. On this basis, Stigler (1971) argued that regulation should be seen as an economic good and specifically a public good in terms of state regulation. Accordingly, regulation is a good, the allocation of which is governed by the laws of supply and demand (Posner, 1974). Stigler (1971) reasoned that regulation was demanded by the regulated entities themselves. Thus, he argued that the regulated had captured the regulator – the idea of regulatory capture was maintained.

On the supply side, it became clear that the government was the supplier of the good (regulation). However, although regulation may be demanded and captured, an elusive question is why would such regulation be supplied? In other words, what incentives does the

[5] A number of sub-theories have developed under the banner of 'Economic Regulation'. Generally these theories can be categorised as either positive theories of regulation or normative theories of regulation. The latter includes theories of market power, interest group theories and theories of government opportunism while the former generally concludes that regulators should encourage competition where possible, minimise the costs of information asymmetries and provide operators with incentives to improve their performance.

regulator have to supply regulation? What incentive does the regulator have to be captured? One can argue that regulators are content to supply regulation since their own livelihood depends on the continued existence of the regulatory agency. Furthermore, the creation of a regulatory agency and the role of other professionals in the regulatory field creates statutory protected employment, which in itself is a policy objective of any government. Lastly, regulation may be supplied by politicians who are seeking campaign money, votes, re-election and political power (Peltzman, 1976). In this regard, regulation may in fact be demanded by politicians and once they gain political power, is then supplied. The latter is extensively investigated more generally in terms of the economics of Public Choice.

In summary and on the supply side, Levine and Forrence (1990:169) point out that there are actors, bureaucrats and professionals in the regulatory universe who process narrow, self-interested goals; principally job retention. There are also politicians who are in the pursuit of re-election, self-gratification from the exercise of power, or perhaps who are in search of post-office-holding personal wealth. In terms of this perspective, government regulation is therefore created and operated for their advantage (Levine & Forrence, 1990:169). The idea of self-interest in terms of which political actors are self-interested maximisers, underpins the idea and was the basic premise of Stigler's formulation of regulatory capture (Peltzman *et al*., 1989). As such, regulators may both demand and supply regulation in pursuit of their own interests whilst proclaiming a public interest justification. The latter is an example of the broader principle-agent problem, one of the most pervasive economic problems worldwide.

Accordingly, the application of the economic theory of regulation to explain regulatory capture, recognises that state intervention serves the interests of politically effective groups and that all groups seek to serve their own interests while at the same time proclaiming that they are acting in the public interest (Stigler, 1971). Stigler's paper attracted widespread support, contributed towards him being awarded the Nobel Prize and he is now accepted as a leading authority on regulatory capture and the economic explanation for regulatory capture (Posner, 1974; Peltzman, 1976).

3.3 Conclusion

For the purposes of this research, two broad rationales for regulation of the financial market are advanced. Firstly, the earliest theories to be put forward are that government intervention,

including regulation, is because it is in the public interest. In terms of this theory, regulation is a tool used to ensure adequate consumer protection even if it is in the form of more obscure and complex concepts such as compensating for market imperfections and increasing total economic welfare. On the other hand, empirical evidence led to the capture theory which is explained by standard economic theory of supply and demand in terms of which regulation is demanded by the industry itself, primarily for its own benefit and does not exist for the public interest in general. Accordingly, regulation factually may not be in the interest of the public at large but rather for the benefit of a specific class of agents whom capture the regulatory process. This was anticipated by Adam Smith's (1790) statement that individuals operate in their own self-interest, including the demand for legislation. The latter forms the linchpin to this ideal. Economic theory of regulation recognises that state intervention serves the interests of politically effective groups and that all groups seek to serve their own interests. Furthermore, the economic theory highlights that human behaviour, and specifically regulatory agencies and politicians seek to maximise their own self-interest and it is this idea which may explain why regulators supply regulation. The capture theory can be generalised as a rule that if it is possible to capture legislation (including regulation) it would be for the benefit of those who have the power to make the capture, rather than regulations existing for the public interest.

Notwithstanding the above theories, in practice, regulators have recognised two principal strands for the regulation of financial markets. These include the need to mitigate the problem of systemic risk and the necessity to regulate market conduct activities in the financial market which together encompass the Twin Peaks regulatory model to be discussed below.

In the sections that follow later on, each period is examined in line with the theories discussed above. The research thus assesses whether the regulatory changes made during a particular period were in the public interest or whether the evidence suggests that regulatory capture took place.

4 TWIN PEAKS OF REGULATION

Mitnick's (1980) definition of regulation is accepted as the point of departure. Mitnick (1980: 5) defines regulation as "... the intentional restriction of a subject's choice of activity by an entity not directly party to or involved in the activity". It therefore follows that regulation is imposed. In addition to this, regulation and supervision collectively denote the establishment of rules and the monitoring and enforcement thereof (Botha & Makina, 2011). Insurance regulation encompasses two facets, namely prudential regulation and market conduct (or conduct-of-business) regulation. These taken together comprise the Twin Peaks of regulation. The distinction between the two classes is however and in most cases, largely illusionary as is illustrated by the near collapse of the Equitable Life, as discussed in succeeding chapters.

According to Llewellyn (1999:9), the three core objectives of financial regulation are:

i. to sustain systemic stability;

ii. to maintain the safety and soundness of financial institutions; and

iii. to protect the consumer.

Naturally, both points i and ii endeavour to ensure consumer protection, however regulators have recently eyed out 'consumer protection' as its own separate policy objective. More specifically, in light of the 2008 global financial crisis, attention has increasingly been focused on consumer protection, encompassing not just financial supervision but also market regulation and oversight of company conduct (NAIC, 2014b). Accordingly, consumer protection has become the cornerstone of regulation and has arisen for two main reasons: (1) because of the possibility that a financial institution which holds clients' money may fail and become insolvent and (2) because of the possibility of adverse and unsatisfactory conduct on behalf of a firm to its customers (Chatterjee, 2011; Goodhart, Hartmann, Llewellyn, Rojas-Suarez & Weisbrod, 2013). For these reasons, insurance regulation seeks to ensure not only that insurers have sufficient assets to make good on the promises they are making but also that insurers treat their policyholders and claimants fairly (NAIC, 2011). As a result of this, regulators are concerned with the liquidity, solvency and conduct of insurance firms and are inevitably bound to regulate their respective activities.

From the above, two generic types of regulation can be identified. These include: i) prudential regulation and ii) market conduct regulation which as mentioned above, comprise the Twin Peaks model of regulation as recently adopted in the UK and worldwide alike. Notwithstanding this, the Twin Peaks regulatory system, as it is known today, is not a new idea as some authors have described it. Although market conduct regulation is a relatively new phenomenon, prudential regulation has a long history after having evolved since the 1870s. Accordingly, although the constitution of the Twin Peaks system may be new, the two regulatory frameworks or peaks are not.

The Twin Peaks system is a form of regulation by objective and one in which there is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervisory function (a prudential regulator) and the other that focuses on conduct-of-business regulation (a market conduct regulator) (G30 Report, 2008: 185). Although prudential regulation and market conduct regulation are regulated separately, they are in fact two related and overlapping regulatory categories since consumer protection objectives underpin both pillars. An overview of prudential regulation and a comprehensive discussion of market conduct regulation are provided below.

4.1 Prudential Regulation

Recently, prudential regulation has sparked renewed interest following a number of events. In particular, recent experience has revealed that financial crises can have a debilitating effect on national economies and this realisation has "reinforced interest in improving financial sector regulation and supervision" (Brownbridge, Kirkpatrick & Maimbo, 2002:1). Following the global financial crisis, it became clear that there was a serious malfunction in the global financial regulatory architecture which prompted a number of national regulators to reflect on their own regulatory bodies and their functioning (Davies & Green, 2008; Goodhart, 2011; Black, 2012). Furthermore, following the global financial crisis, the parameters of prudential regulation have been redefined with a greater focus on financial stability and macro-prudential regulation (Tarullo, 2014). As such, Solvency II and the various Basel agreements seem to be buzz words when it comes to prudential regulation today.

It has been cited that "a stable financial system provides a favorable environment for economic growth" (Davies & Green, 2008:20). However, when such markets are left

unregulated, they may experience bouts of instability and contagion (Davies & Green, 2008; Goodhart *et al*., 2013). The latter is supported by the fact that financial meltdowns have tended to escalate in more liberalised markets (Davies & Green, 2008). As such, if regulation can reduce the likelihood of systematic failures, without unreasonably constraining the market, then there is a strong case for such regulation which aims to promote a stable financial system (Davies & Green, 2008; Botha & Makina, 2011).

The objective of prudential regulation is thus to promote the liquidity, solvency, safety and soundness of the general financial system in addition to delivering an appropriate degree of protection to policyholders (Llewellyn, 1999; Adams, 2013). In other words, with specific reference to the insurance market, the aim of prudential regulation is to prevent insurers from incurring excessive financial risk that may result in insolvency (Skipper & Klein, 2000). This is done by ensuring that insurance firms have sufficient assets to cover their liabilities and that a firm's risks are adequately and appropriately managed (Ford, 2011:252).

Prudential regulation further aims to ensure that prevention measures and intervention mechanisms are in place to keep insolvency costs at a minimum when an insurance firm experiences financial difficulty and in doing so safeguards policyholder protection (Skipper & Klein, 2000). The latter is undertaken by ensuring that insurance companies are capable of meeting their obligations to customers in terms of legitimate claims payments in addition to ensuring that firms are soundly organized and hence capable of paying said claims (KPMG, 2013; Adams, 2013). This is accomplished through the imposition of minimum financial standards and risk based capital requirements in addition to the effective monitoring of a firm's internal controls and overall financial condition (Skipper & Klein, 2000; Daykin & Cresswell, 2001).

In summary and according to KPMG (2013:7), the objective of prudential regulation is to:

- Create and monitor an effective regulatory environment
- Ensure that financial institutions are licenced and registered
- Promote financial stability and combat financial crises
- Supervise financial institutions

- Prescribe good practice standards and monitor and enforce compliance thereto
- Identify, evaluate, control and mitigate excessive risks and deregister those high risk firms to minimise losses
- Implement policies, systems and procedures to mitigate excessive risk taking
- Monitor reserve fund allocations to ensure that firms retain adequate reserves
- Implement early warning systems to identify excessive systematic risks

Within the insurance context, the argument for prudential regulation is founded on the fact that the failure of an insurance company can create a whole host of potential externalities that are not easily internalised (Davies & Green, 2008). In other words, the failure of a large insurance company that offers a retirement annuity can have widespread ramifications and may leave the elderly in a vulnerable position. In addition to this, the basis upon which prudential regulation is necessitated is that consumers often lack the mental models required to judge the safety and soundness of a financial institution. This means that consumers are at a comparative disadvantage to expert professionals in the insurance market who are presumed to have greater knowledge of insurance products and terminology (Goodhart, 2011). The problem of 'imperfect consumer information' is further aggravated by the lack of relevant information, the inability to assess the information that is available and the high transactions costs involved in doing so which makes it difficult in practice for consumers to judge the financial condition of the respective institution (Llewellyn, 1999:18). In addition to this, where consumers may in fact be able to make informed decisions, fraudulent financial reporting may nonetheless warrant the need for a financial watchdog to prevent subsequent exploitation of policyholders and customers alike (Llewellyn, 1999).

4.2 Market conduct regulation

Although no definition exists in legislation, the terms 'conduct of business regulation', 'market conduct regulation' and occasionally 'retail regulation' which are used in various jurisdictions, refer to the way in which firms and their intermediaries should interact with their customers in terms of product distribution and sales, advertising, advice and claims handling (Chatterjee, 2011; Ford, 2011; The World Bank, 2013).

The objective of such regulation is to prevent abusive market practices, including the making of false sales illustrations and advertising, the failure to pay legitimate claims on a timely basis and the unfair taking advantage of consumers (Klein, 1995: 374). As such, regulators view market conduct as being critical to ensuring the welfare of consumers and maintaining public confidence in the insurance industry (NAIC, 2014b). Market conduct regulation therefore endeavours to establish internal controls, codes of conduct, rules and guidelines about appropriate behaviours and business practices when dealing with customers (Goodhart *et al*., 2013). As such, market conduct regulation is generally restricted to the relationship between a firm and its client and is therefore subject to both the rules derived from insurance contract law and the rules pertaining to market conduct (Smethurst *et al*., 2011). Modal regulatory strategies include mandatory information and commission disclosures, anti-fraud measures, the duties of care, skill, diligence, fair dealing and best execution and the honesty, integrity and the level of competence of firms and their employees (Llewellyn, 1999; Tuch, 2014).

In addition to this, market conduct regulation is aimed at mitigating principal-agent conflicts of interest thereby raising the quality of information provided and ensuring that customers receive 'best advice' and the most suitable product (Pacces, 2000; Smethurt *et al*., 2011). In fact, Pacces (2000:482) notes that without such protection, quality uncertainty would inevitably characterise the market and accordingly consumers would lack the confidence needed to enter into financial transactions. The objective of market conduct regulation is therefore to improve insurer, intermediary and consumer relationships and in doing so, strengthen consumer confidence and protection, facilitate cross border business, encourage competition and protect the integrity of the market (International Association of Insurance Supervisors, 1999 as cited in Smethurst *et al*., 2011). As such, the development of "equitable, sustainable and transparent insurance markets is an important goal of customer protection laws and regulations" (Chatterjee, 2011: 508).

Furthermore, consumers often lack a comprehensive knowledge of insurance products and jargon in order to appreciate the nature of such a transaction. In fact, the International Association of Insurance Supervisors (2009 as cited in Smethurst *et al*., 2011) noted that:

> Consumers may not be able to detect contracts which could be biased in favour of insurers, which may be unreasonably interpreted to favour the insurer or which simply fail to meet their needs. Marketing methods could

> place potential policyholders under pressure. There could be other anti-consumer practices that support the need for sound market conduct principles.

In other words, since consumers are imperfectly informed, this may give rise to the potential for insurer misrepresentations and manipulation (Chatterjee, 2011: 508). As a result of this, market conduct regulation is also justified on the basis of asymmetric information and accordingly seeks to rectify any unfairness and imbalances which may arise from a greater knowledge of insurance products by both insurers and intermediaries (Pacces, 2000; Mishkin, 2004; Smethurst *et al*., 2011). Governments therefore address these issues through regulation that, among other things, requires insurers to disclose certain information to the public (Botha & Makina, 2011:29).

Consumer protection as part of the broader market conduct regulatory approach has only recently emerged as a distinct regulatory category separate from prudential regulation[6] and further encompasses i) the regulation of policy forms and premium rates to ensure consumers are charged fair and reasonable insurance prices, ii) the provision of consumer education, iii) the administration and monitoring of market conduct examinations, iv) the investigation of specific concerns or consumer complaints and v) the review and resolution of consumer disputes[7] which collectively attempt to ensure that consumers have access to beneficial and compliant insurance products, and are protected against insurers that fail to operate in ways that are legal and fair to consumers (Kochenburger & Salve, 2011; NAIC, 2011: 3). In this regard, "the object of market conduct regulation is to ensure that an insurance company discharges its obligations to its [policyholders] in terms of the contract between the company and the insured for all valid claims reported to the company" (Vivian, 2014: 2). Accordingly, regulators police insurers' and agents' sales and underwriting activities to ensure that they adhere to certain standards and that claims are handled fairly (Klein, 1995: 374).

The content of market conduct rules, in any jurisdiction, is driven by national policy directives mostly with due regard to the protection of customers and the maintenance of appropriate standards of conduct (Smethurst *et al.*, 2011:359). Nonetheless, market conduct regulation has increasingly taken on a wider meaning and no longer only encompasses long established consumer protection measures and compliance with traditional conduct rules

[6] In fact, market conduct regulation is said to have been evolving since the late 1980s (Vivian, 2015a).

[7] The regulatory oversight and monitoring of market practices involving sales, advertising, underwriting and claims is an important aspect of any modern regulatory structure.

(Norton Rose Fulbright, 2014). Nowadays, 'fit and proper' requirements, corporate governance, systems and controls, board competence and oversight, minimum ethical standards and product governance are all characteristic of market conduct regulation (Norton Rose Fulbright, 2014). At the very least however, market conduct regulation generally requires that firms conduct their business with integrity, due care, skill and diligence, observe proper standards of market conduct, pay due regard to the interests of customers, communicate information in a clear, fair and non-misleading manner and most importantly, treat customers fairly[8] (Davies, 2001:282). Notwithstanding this, the term 'market conduct regulation' has a fluid meaning which means that a number of new issues and regulated activities often fall under the banner of conduct regulation (Norton Rose Fulbright, 2014).

4.3 Market Conduct and the Lockean Model

Traditionally there has been no need for market conduct regulation since the relationship between a service provider and a consumer has always been regulated by virtue of the law of contract. Furthermore, the courts have historically played the role of enforcing such contracts in order to ensure that each party fulfils their respective obligations. Regulators therefore need to be cautioned against applying market conduct regulation too rigidly and should further acknowledge the role of the law of contract in the market. In fact, Vivian (2015c) argues that there can be no substitute for governing the relationship between a client and the service provider other than the law of contract.

Since it has been argued that the relationship between two contracting parties should only be regulated by virtue of the law of contract, it therefore becomes necessary to explore what is meant by this idea. For purposes of this thesis, the South African Common Law will be explored. Since the South African common law is Roman-Dutch in origin, this ought to be the point of departure. The common law however is far more Roman than Dutch (Vivian, 2006b: 42). One may argue that this is owing to the fact that historically judges had difficulty

[8] This is now widely known as the TCF principle. Such a principle seems to have existed for more than a century in what was called the "Advice to Bankers of 1863". The latter, a letter addressed to all national banks from Hugh McCulloch (then Controller of the Currency and later Secretary of the Treasury), asserts that banks should "treat [their] customers liberally, bearing in mind the fact that a bank prospers as its customers prosper". As such, the principle of 'treating customers fairly' is not a new phenomenon but has merely attracted greater attention in recent times.

applying Dutch law, largely because of the unavailability of sources and the language barriers. As a result of this, an examination of Dutch law therefore becomes trite. An understanding of the historic Roman law position thus becomes more relevant.

Historically, Roman law did not have a general doctrine of contract but rather recognised a number of specific types of contracts and was therefore referred to as the law of contracts (Buckland & McNair, 1965). These contracts were either nominate (or named) contracts or innominate (or unnamed) contracts (Van Niekerk, 1999). In particular, four nominate contracts existed. Each of these contracts had their own *causa* or "formal positive act" that ought to have been performed in order for a valid contract to come into existence (Lorenzen, 1919). In addition to this, a number of innominate contracts existed which could not be classified by a particular name.

Historically, the status of each party to the contract determined each of their respective rights and obligations (Vivian, 2006b). More specifically, although not widely understood by many academic writers[9], the rights and obligations that underpinned each contract were determined by the nature of the relationship between the two contracting parties and not by what they specifically agreed to.[10] Conversely, the type of contract determined each party's status and their status in turn determined the party's obligations. Contract names thus reflected the type of relationship that existed between the two parties. Examples of this include the tenant-landlord contract (akin to the modern day lease agreement), the master-servant contract (similar to the modern employment contract) and the purchaser-seller contract (which today is known as a sale agreement).

The person's status in terms of the contract would thus determine their rights and duties. More specifically, if an individual was a tenant, by virtue of this status, the law of Landlord

[9] It can be argued that Graveson (1941), like many, interpreted status as the class of persons to which the contracting party belonged.

[10] This approach challenges the well noted interpretation, which as noted above, argues that status rather reflected the class of persons to which you belonged. In terms of this approach, depending to which class-based social structure the individual belonged, their rights and obligations were derived therefrom. The question then arises as to whether or not a person belonging to a class of *pecus* would have received less protection under the law of contracts. This does not appear to be the case and accordingly, the interpretation provided by this author appears to be more conceivable. Furthermore, since the contract name reflected the relationship between the two contracting parties, this further serves to strengthen the latter interpretation.

and Tenant would regulate the relationship. If the individual had been engaging in a sale, by virtue of said status, the law of Purchase and Sale would spell out each respective party's rights and obligations. The respective law (and not the actual contractual wordings) would therefore define each party's rights and obligations. The rights and obligations which reinforced each contract type largely became understood by the community at large and hence over time, parties knew their rights and obligations without independently reaching consensus on the *naturale* of the contract.

Over time however, there was a growing recognition that a general doctrine of contract should exist so as to allow contracting parties to consent to specific contractual terms and thereby voluntarily expand or limit the scope of their own liability. This was largely owing to the number of problems which were inherent in the system of status and by virtue of this, a system of specific contracts. Recall that the insurance contract was unknown in Roman law and accordingly matters concerning insurance would need to be "forced" (by analogy) into one of the existing and specific contracts in order to find a workable solution (Vivian, 2006). It became increasingly difficult to do so through the law of analogy as specific problems and specific cases often could not be "forced" into one of the specific contracts and related laws (Vivian, 2006b). The system therefore became unworkable and fell into disuse more than 200 years ago.

As a result of this, a transition took place from the law of contracts to the law of contract in terms of which the basis of contract is consent (Vivian, 2006b; Coote, 2016). This movement is reflected in Sir Henry Summer Maine's (1861) famous, albeit misinterpreted, statement where he pointed out that society has evolved and through this evolution there has been a movement "from status to contract". Rights and duties are therefore no longer defined by law as a consequence of one's status, but rather depend on the will of the parties who effect them (Graveson, 1941: 261).

In terms of this modern law approach, today all contracts are therefore consensual contracts (Coote, 2016). That is, the parties to the contract ought to reach consensus (agreement) on the specific points, objects or essential elements of the contract (Van Niekerk, 1999). This is often referred to as the *essentialia* which in turn, determines the classification of the specific contract (Sharrock, 2011). It therefore follows that without consensus, a valid and enforceable contract cannot arise. Consensus also implies a degree of freedom in terms of

which parties can freely and voluntarily reach agreement as to the particulars of the contract. The latter forms the starting point of the works of a number of jurists, philosophers and natural law advocates.

In particular and as discussed above, individuals have, amongst other natural rights, the right to liberty. As a result of this, individuals can act with absolute freedom as long as they do not infringe upon the natural rights of others. It therefore follows that individuals can assume obligations freely and voluntarily through the law of contract (provided that doing so does not violate the life, liberty or property of others). Locke (1689/2005) emphasised these natural law ideas in order to promote the concept of freedom of contract. The freedom of contract ideals were viewed by Locke as "a fundamental human freedom, in which man [is] free to regulate his own conduct" and which is "free from any interference" (Lerm, 2008: 367). This philosophy was further reinforced by Hobbes in the sixteenth and seventeenth centaury. Hobbes (1588–1679) noted that

> The right of nature, which writers commonly call the *jus naturale*, is the liberty each man hath, to use his own power, as he will himself, for the preservation of his own nature, that is to say, of doing anything, which in his own judgement, and reason, he shall conceive to be the aptest means thereunto.

According to Atiyah (1985 as cited in Lerm, 2008: 367) the natural law ideas of both Locke and Hobbes, as expressed above, can be summarised as follows:

i. Human beings are free from control by others; what men do, they do freely

ii. Relationships with other human beings are voluntarily entered into out of motives of self-interest

iii. The individual is essentially the proprietor of his own person and capacities; he can alienate his own labour by a contract which is perceived as a disposal of something belonging to the individual in much the same way as alienation of his land or his goods

iv. Human society consists of a series of market relations

It therefore follows that when the state imposes certain regulations on the market, it is infringing upon the liberty of others; it is not taking the law of contract into consideration. It

was thus the writings of Locke and Hobbes which popularised the concept of freedom to contract and which highlighted the importance of the law of contract. Thereafter, during the eighteenth and nineteenth century, Adam Smith advocated the *laissez-faire* economy in terms of which he supported "a free political economy, free of state interference and the enhancement of freedom of contract" [11] (Lerm, 2008: 377). He did so by emphasising the freedom of an individual and in doing so, stressed the value of the doctrine of freedom of contract.

The freedom of contract doctrine, as it is known today, therefore entails that individuals be able to decide with whom they wish to contract, negotiate freely the terms of their agreement, and of particular significance is the notion that full legal effect should be given to such agreements with little scope for judicial interference (Chrenkoff, 1996; van der Sijde, 2012:10). Accordingly, individuals have "exclusive control over their private domain of autonomy in which the role of the state is limited and in which legal relationships are defined by free consent on the assumption that consent is a manifestation of individual autonomy" (Stoop, 2015:191-192). Individuals can contract freely provided that the requirements for a valid contract are upheld. A consequence of the freedom to contract is therefore to maintain the sanctity of the contract in terms of which contracts should be upheld and the terms should not be altered by the courts.

The courts have thus traditionally enforced contracts as expressed in the rule *pacta sunt servanda* in terms of which the agreements and stipulations of the contracting parties must be observed. The latter was recognised by the judgement made in *Bredenkamp v Standard Bank* ZASCA 2010 075. Although a banking case, the court's interpretation of contract law is nonetheless important. It was held that the terms of the contract ought to be upheld provided that these terms do not undermine any Constitutional norm or public policy. In doing so, the court held that an assessment of the reasonableness and fairness of the contract terms is trite.[12]

Sir George Jessel MR recognised this notion and remarked over a century ago that

[11] The doctrine of freedom of contract is also rooted in Adam Smith's Inquiry into the Nature and Causes of the Wealth of Nations.

[12] The views held in this case are in stark contrast to those expressed in in *Barkhuizen v Napier* 2007 ZACC 5. In terms of this case, the judge held that a policy should be adjudicated with fairness and reasonableness in mind. This judgment has not been beyond criticism.

> It must not be forgotten that you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this paramount public policy to consider—that you are not lightly to interfere with this freedom of contract.[13]

The ethos of the law of contract, the doctrine of freedom of contract and the due process of the law nonetheless seems to be overlooked specifically following the advent of market conduct rules and regulations, the promotion of consumerism and the introduction of standardised contracts and policy wordings (Lerm, 2008). In particular, legislation that implements fairness, welfarism and consumer protection has increasingly impacted on the traditional basis of contract law (Stoop, 2015: 193). Furthermore, consumer protection legislation has led to more equitable considerations in terms of which greater weight is now attached to considerations of fairness and justice (van der Sijde, 2012). This has resulted in a number of adverse effects since an individual's autonomy, personal liberty and freedom to contract have been impeded. The array of new market conduct regulations and the birth of new quasi-judicial institutions have also largely replaced the rule of law and law based decisions respectively (Vivian, 2012). In many instances, these regulations and decisions are incompatible with existing law which means that the historical system of the law and the courts is being rejected (Vivian, 2012). As such, it can be argued that the plethora of consumer protection laws and regulations may undermine the rule of law and an individual's freedom since the rule of law makes freedom more probable[14] (Hayek, 1960 as cited in Louw, 2015; Vivian, 2015d).

Consumer protection legislation and regulation (that is usually in favour of the policyholder) has also meant that commercial and contractual certainty has been hindered (Stoop, 2015). That is, firms and companies are no longer certain of the obligations to be fulfilled since market conduct regulations may move the proverbial goal posts. A firm and in particular, an insurance company, can only survive if it knows the potential liabilities that it may face in the

[13] This view was further reinforced by the Appellate Division in *Wells v SA Alumenite Co* 1927 AD 69.

[14] The rule of law is particularly important since according to section one of the Bills Of Rights, South Africa shall be founded on, amongst other things, "supremacy of the constitution and the rule of law". Furthermore, article 39 of the Magna Carta re-affirmed the Rule of Law in terms of which only judgements by an independent court in terms of the law of the land and the common law are permitted (Vivian, 2015g).

future by holding certain reserves. It cannot do so when its obligations are reinterpreted beyond the scope of the contract. The application of market conduct regulation and accordingly, the non-application of contract law, can itself result in the demise of a financial institution (Vivian, 2015c). Accordingly, market conduct regulation has been criticised for its destructive nature. The near collapse of the Lloyd's market in the 1990s illustrates this point. The latter is discussed in section 5.1.1.2 below. Within the South African context, the downfall of the Auction Alliance, although not an insurance matter, is illustrative of this point.

In December 2011, Auction Alliance conducted the auction of Quoin Rock Winery on behalf of the liquidators of Dave King's estate who at the time was embroiled in a dispute with the South African Revenue Service. The highest bidder at the auction was Wendy Appelbaum who later disputed the auction process on the grounds that Auction Alliance (and the then CEO Rael Levitt) used a vendor bidder[15] to bid against her and in doing so, artificially drove up the price of the wine estate. Appelbaum thereafter lodged a complaint with the National Consumer Commission (NCC) after alleging that the auction did not comply with the Consumer Protection Act of 2000. After its investigation, the commission imposed a R32 million fine on Auction Alliance. It is important to note however that the NCC at no point had either the power or the authority to make judgments or impose fines. It is merely an investigative body. Furthermore, the NCC seemingly ignored the crux of the problem; that which is formally known as vendor bidding. In terms of the common law, vendor bidding has always been lawful (Vivian, 2015d). Furthermore, according to Section 45 of the Consumer Protection Act of 2000, vendor bidding is legal as long as the bidder is notified beforehand. More specifically, Section 45(5) of the Act states that

> unless notice is given that a sale by auction is subject to a right to bid by, or on behalf of, the owner or auctioneer: (a) the owner or auctioneer must not bid or employ any person to bid at the sale; (b) the auctioneer must not knowingly accept any bid from any such person, and; (c) the consumer may approach a court to declare the transaction fraudulent if this undertaking has been violated.

Despite the fact that Auction Alliance maintained that it had made such a disclosure and accordingly complied with the provisions of the Consumer Protection Act, the Commissioner of the NCC, Mohlala Mulaudzi, maintained her position and imposed a fine equivalent to

[15] Also known as "ghost bidding"

10% of Auction Alliance's annual turnover. In addition to this, the commission approached the Estate Agency Affairs Board to withdraw Auction Alliance's fidelity fund certificate. The net result was the destruction of Auction Alliance when a perfectly valid contract had existed. The rule of law had been singlehandedly obliterated.

On the other hand, the rule of law was correctly applied in the recent case of *Ichikowitz v High Street Auction Company* ZASCA 2015 54 which exhibits a number of similar features to the Auction Alliance case. In November 2011, Ivor Ichikowitz had similarly accused the High Street Auction Company of faking bids to inflate the price of a property he was buying. However in this case, the matter was correctly taken to the High Court (and eventually the Supreme Court of Appeal) and not to the consumer protection watchdog. In fact, it was the first time that the courts were tasked with dealing with the idea of vendor bidding. The court approached the matter via the law of contract and in doing so applied centuries-old common law, thereby resolving the matter efficiently and equitably. On appeal, the Supreme Court stated that the High Street Auction Company had not transgressed since it was clear on the sale advertisements and the registration form that the High Street Auction Company would be acting for the sellers and making bids on their behalf.

The Supreme Court of Appeal ruled that Ichikowitz had not been induced to enter into the contract through a material misrepresentation and had "only himself to blame for ignorance of the possibility of vendor bidding by the auctioneer" (SA Commercial Prop News, 2015). This notion is embedded in Babington's (1826) "Treatise on the Law of Auctions" in terms of which it was noted that:

> But there is no doubt that the owner may appoint one person to bid for him, for the purpose of guarding against a sale of his property taking place at less than its value, and that a purchaser at such sale, will be bound to complete his purchase, whether notice of the appointment of such bidder was given or not. This is a rule founded in reason and equity, for by it the seller is enabled to protect himself against the tricks, which might otherwise be practised upon him by bidders.

In addition to this, the court observed that since Ichikowitz took a deliberate decision to raise his bid in order to meet the reduced reserve price of R20 million, any prior misrepresentation did not induce the agreement of sale. Furthermore, since there was an offer which was accepted, in terms of the law of contract stretching back to the Roman era, a valid contract

had thus came into existence. The Supreme Court of Appeal confirmed the decision of the High Court that a binding contract was concluded at the auction.

Resolving the matter via the age-old laws and the courts (through the Lockean framework) resulted in a "non-event" for the High Street Action Company (Vivian, 2015d). Resolution was via a court of law following the due process of law by learned judges in the law as envisaged by John Locke. The courts took all the same statutory provisions into consideration as the commissioner did but these were only relevant to the extent that they impacted on the contractual arrangement. Resolving the matter in terms of a regulatory body that had no regard for the legal and procedural frameworks in which to operate, conversely had amounted to the destruction of the Auction Alliance. Modern rules and regulations which attempt to treat customers fairly, simply undermined and confused the clear common law of auctions. It is therefore imperative that the separation of powers between the executive and the judiciary is restored and that the application of the rule of law is reclaimed (Vivian, 2015d).

In summary, the two cases discussed above therefore highlight two pertinent issues as emphasised by Vivian (2015d):

i) If the law of contract is undermined, virtually all commercial transactions become uncertain and thus the importance of upholding the law of contract cannot be overemphasised.
ii) Market-conduct regulators, such as the NCC, can destroy businesses as well as the rule of law.

The law of contract is increasingly becoming irrelevant and therefore they have pointed to the 'death of contract' (Vivian, 2012). It is for this reason that it has been argued that there is a move back to the impractical and problematic doctrine of status. In particular, where judicial interpretations (although this was not the case in the above mentioned matter), legislation, rules and regulations begin to impose obligations beyond the bounds of the contract, one can argue that the law is reverting back to a system as defined by status. In other words, where contracting parties are no longer consenting to the *essentialia* of the contract but are forced to transact by virtue of the nature of their relationship, they are doing so under a system of status. It would then appear that legislatures and regulators are forgetting why society developed "from status to contract" and policymakers may therefore be reverting back to a system of specific contracts which as pointed out above is unworkable (Vivian, 2006b). This

concept has been understood by few but appears to be the case particularly in the broker market. Three cases can be used to illustrate this.

In *Stander v Raubenheimer* 1996 2 SA 670, an insured sued a broker alleging that the broker should have inquired and thus disclosed the fact that the insured house had a thatched roof. Prior to this, the insured had requested his broker to inform his insurer of his change of address since he had recently built a new house. The broker did so and the household contents insurance cover was renewed. Subsequent to this, the house and its contents were destroyed by fire after which time the insurance company (SA Eagle) repudiated the claim on the basis of a material non-disclosure, although the insurer did make an *ex-gratia* payment of R30 000. Notwithstanding this, the insured sued the broker for the difference, alleging that the broker should have asked if the house had a thatched roof, after which time he ought to have disclosed the fact to the insurer. The broker had not. The court of first hearing ruled in favour of the broker, however, on appeal, the broker was held liable. The question therefore arose as to how the duty of disclosure that has been imposed on the insured party for centuries had passed on to the broker. In arriving at their ruling, the courts relied on the testimony of an expert witness who pointed out that "brokers always check these things" (Vivian 2006b: 42). Despite the fact that the broker did not agree in contract nor consent to such an undertaking, he was held liable simply because of his status (Vivian 2006b: 42). His status as a broker and not his contractual undertaking, had therefore determined his rights and duties.

In *Lenaerts v JSN Motors (Pty) Ltd and another* 2001 4 SA 1100 W, the insured sued the broker alleging that the broker should have notified him of the territorial limitation clause, on the basis of which the insurance company repudiated the insured's claim. The courts, with the aid of an industry expert once again, adopted the view that brokers are required to advise their clients about contractual terms and accordingly, by consequence, the territorial exclusion ought to have been highlighted. Despite this, no evidence existed which suggested that the broker had agreed do so in terms of a contract. The broker was held liable because that was what was expected of a broker. The broker's status had dictated his obligations (Vivian 2006b: 42).

The most recent case involving broker liability, considered the application of average for underinsurance and a broker's duties. In terms of this matter that went before the FAIS

ombud, an insured complained that he was underinsured and was therefore subject to the average clause, that which his broker had not discussed with him. Shockingly, the FAIS Ombud noted that the broker should be liable since he had failed to explain to his client that in the event that he had underinsured that he would be deemed his own insurer for the uninsured balance. The broker subsequently accepted liability and made a settlement. The broker was therefore liable to pay a large portion of the insured's uninsured portion of the loss although no obligation existed which compelled him to do so. That is, in terms of the modern day law of contract, the broker would only be held liable if i) he had agreed to such an undertaking and agreed that such an obligation was material and ii) breach of the material term should therefore attract liability. No such contractual agreement existed between the broker and the insured and thus the broker did not breach any obligation to which he ought to be held liable. The broker's liability therefore did not stem from any contractual breach but rather from what the FAIS ombud had expected of him, by virtue of his status alone (Vivian, 2012). The contract therefore became irrelevant.

The three cases noted above[16] all serve to illustrate the transition from contract back to status. That is, in all three cases, the basis of liability was founded upon the broker's position (status) as a broker and not on any contractual agreement. It is at this point, that the great Roman jurist, Gaius, is worth mentioning. One of the great truths is encapsulated in his statement where he states: "Let us now proceed to obligations. These are divided into two main species: for every obligation arises either from contract or from delict". Accordingly, obligations can only arise from contract or delict and not from another source. Since the law of delict did not apply in any of the three cases discussed above, the only other basis on which the broker ought to have been held liable is contract. This was not so.

Therefore, as the contract becomes less important, as it dies, the system moves ever closer to a system of status which as mentioned above was deemed to be unworkable almost 200 years ago. Furthermore, as this approach is restored, a broker faces ever increasing liabilities of which he is unaware, and which certainly do not comply with Gaius's great statement (Vivian, 2006b). This in turn will have all sorts of implications on the broker market since all transactions become uncertain. As such, both the judicial system and regulators who are impinging on the correct application of the law of contract, be it through similar judgements,

[16] Similarly, the UK case of *McNealy v West Lanc Insurance Brokers Ltd* 1978 2 Lloyd's LLR 18 CA has also seen the courts holding brokers liable without any evidence of a contractual breach.

or the imposition of market conduct regulations (which may expand obligations beyond contract), appear to have not learnt from history. For this reason, history will indeed repeat itself.

Since the law of contract and the freedom to contract underpin and make possible the many private and voluntary agreements by which the exchange of goods and services are accomplished, without contract law such voluntary agreements would become impractical and unworkable (Markham, 2002). It therefore follows that since such agreements support both society and the economy, and since they depend upon contract law, "contract law lies at the heart of our system of laws and serves as the foundation of our entire society" (Markham, 2002: para 4). As a result of this, the application of the law of contract is paramount and should never be undermined by consumer protection rules and regulations that reinforce the market conduct regulation ideals.[17]

4.4 Conclusion

Historically regulation has focused on consumer protection, encompassing both financial supervision and market conduct regulation. Accordingly, regulation has endeavoured to ensure that insurers i) have sufficient assets to meet future obligations and ii) treat their policyholders and claimants fairly. The latter is known as market conduct regulation whilst the former is referred to as prudential regulation.

Following the global financial crisis, greater attention has been directed toward the separation of prudential regulation and market conduct regulation in order to enhance consumer protection by separately focusing on customer treatment objectives and financial stability

[17] Notwithstanding this, the law of contract and the doctrine of freedom of contract have themselves attracted criticism. In particular, the doctrine assumes that contracting parties have the necessary knowledge and information to his or her avail and are able to protect their own interests. In many instances, as has been discussed in earlier chapters, consumers lack the technical knowledge, mental models, legal understanding and resources that are required to make discerning decisions and to appreciate an insurance transaction. As a result of this, a lack of informed consent may arise. In addition to this, the traditional contractual ideologies and freedom-orientated approach have been criticised further since it is purportedly non-contextual and may not necessarily take social realities into account (Edwards, 2009; Stoop, 2015). Regulation is accordingly applied to address the various shortcomings inherent in the freedom of contract approach (Stoop, 2015).

goals. An endeavour has been made to achieve both the latter and the former through the creation of two separate regulatory agencies who are responsible for regulating a single policy directive by virtue of the Twin Peaks regulatory model. In particular, one regulator is concerned with ensuring the financial viability of the market whilst the other is concerned with regulating the market conduct or conduct of business of the market. The various policy objectives and mandates of each regulator have been outlined above.

Although it has been emphasised that only the law of contract can govern the relationship between a consumer and the service provider, market conduct regulation continues to evolve and today is the 'buzz word' in financial regulation. The impact of this is that market conduct regulation is increasingly ignoring the role of contract law in the market and in doing so can become devastatingly destructive. In particular, the destructive nature of market conduct regulation can be seen particularly where it expands the obligations of a financial institution beyond that which was voluntarily assumed in a contract. The potential for such ruin is becoming increasingly more apparent as the application of market conduct regulation expands.

In addition to ensuring the strict application of the rule of law and the law of contract, regulators should be cognisant of the potential adverse outcomes when a regulatory system is too complex. As noted above, an intricate regulatory system can be very destructive and the cost of this is ultimately borne by the consumer. Regulators should therefore be cautioned against implementing a regulatory system that stifles innovation, elevates product pricing and marginalises the lower end of the market from accessing financial products. Regulation is therefore a tricky balancing act which requires a careful equilibrium between adequate consumer protection and complex regulatory rules and provisions. Notwithstanding this, and worth emphasising again, no system should ever substitute the long standing rule of law and specifically the ever important law of contract.

Now that regulation and its various facets have been explored, the following section examines the history of insurance regulation in the UK and in doing so, maps out the role of government in terms of their involvement in the regulation of the industry.

PART II: UNITED KINGDOM

5 UNITED KINGDOM

The UK is the oldest insurance market and historically is the most influential, especially in South Africa. Accordingly, it is useful to start with a discussion of the insurance market and its regulation in the UK since these developments had a strong bearing on the development of the insurance market and related regulation in South Africa. It is for this reason that an in-depth discussion is provided on this particular market. This development lends itself to a series of different periods as discussed below. This chapter therefore traces the history of insurance regulation in the UK with a specific focus on market conduct. As such, market conduct issues for each period which are under review are discussed. This chapter examines the key regulatory developments that have taken place in the UK insurance market and explores the various market events, scandals and failures which are said to have been the impetus for regulatory reform. These have also been set out in a series of articles published for the insurance industry. See Vivian, MacGregor, van Vuuren (2015a; 2015b; 2015c; 2015d; 2015e; 2016a; 2016b; 2016c) .

In recent years, the UK has enacted a large quantity of legislation including subordinate legislation and rules.[18] Historically, changes to regulation were generally driven by country-specific factors (Ferran, 2003:259). The latter theory applies to the UK where some of the impetus for change came from "local financial scandals and collapses that were attributed, in part, to failings in the old system" (Ferran, 2003: 259). Some of these developments are set out below, however a broader, umbrella approach is taken and as such, this section aims to cover the main insurance regulatory developments in the UK. The following sections examine the various incidents that may have given rise to regulation and specifically, market conduct regulation. It is necessary to discuss the regulation of insurance as far back as 1601 in order to provide a complete and coherent account of insurance regulation. However it becomes clear that market conduct regulation, as it is currently understood, has a more recent origin, starting in the UK in the 2000s.

[18] Up until the passing of the Financial Services Act of 1986 the UK market was essentially self-regulated. Notwithstanding this, the 1986 Act was itself also designed with self-regulation in mind.

5.1 British Insurance Market

5.1.1 Regulation of the insurance market up to 1720

5.1.1.1 Elizabethan era (1558-1603)

No substantive investigation has been undertaken into the history of insurance in England, prior to 1601 which includes the Elizabethan Chamber of Assurances (Ibbetson, 2008:291). A review of literature on the subject, or the lack thereof, bears testament to this. Investigations into the early history of insurance in England were conducted during the period of war during which much useful material had been removed from London (Raynes, 1948). In addition to this, the early records of the Office of Assurances, the earliest period of the English insurance market, were destroyed by the Great Fire of London in 1666 (Walford, 1885). For this reason, the historical work on the history of the Office has not done it justice. Thus, the chapter in Raynes' (1948) '*History of British Insurance*', augmented recently by others is an immensely valuable piece of research and accordingly lays the foundation for the following section.

It appears that at first (1576) "insurance was in the hands of the Italian merchants meeting in Lombard Street in London" (Ibbetson, 2008: 292). The English word 'policy' is derived from the Italian *polizza* which refers to a promise or undertaking (Longnaker, 1962). Evidence suggests that by the 1540s, policies of assurance were being made by English merchants, although they were still written in Italian (Van Niekerk, 2011).

It is therefore accepted that in the UK, insurance started to develop in the late 1500s and soon attracted regulatory attention. Over time, marine assurance "as being part of the machinery of commerce, came within its [the Privy Council's] careful purview and became subject to regulation" (Raynes, 1948:41). This may have been the result of a series of complaints received by the Privy Council in the early 1570s about difficulties that foreign assureds (and some English assureds) were having in securing payments from underwriting merchants who allegedly were not keeping their promises (Purvis, 2000). The Privy Council was determined to foster the health of marine insurance in the City of London in order to maintain and promote its standing as an emerging insurance market[19] (van Niekerk, 2011). Accordingly, matters of trade were regarded as of the highest importance (Raynes, 1948: 44). The Privy

[19] It was during the 16th century that London rapidly started to become the centre of the commercial world, especially as a leading insurance market (Lloyd's, 2010).

Council responded in writing and surviving letters to the Lord Mayor further emphasised their concerns over such "dealings [that] tended to discredit the City" (Raynes, 1948:45). It is clear that the earliest complaints fall within the domain of what is today called Market Conduct.

At this time, it appears that insurance disputes were dealt with by merchants themselves, a form of self-regulation since it was the view that they knew the insurance practice, customs and traditions (Ibbeston, 2008; Van Niekerk, 2011). A number of early policies therefore contained a type of 'arbitration clause' which stated that any dispute arising from said policy should be referred to a group of merchants without going to law (i.e. the judicial system) (Raynes, 1948). However, by the 1550s, court involvement in some claims arising out of policies was on the rise. The view began to form that the system in general was not working well and again the Privy Council felt constrained to intervene (Ibbestson, 2008). The impetus behind this was three-fold, according to Ibbestson (2008).

Firstly, individuals, involved in policy disputes, may have felt that their interests were better served through law than through merchant arbitrators. Secondly, as the insurance market began to grow and insurance policies became more complex, some cases raised a number of difficult issues. The sentiment at the time was that where there was no settled practice or custom, the advice of merchants was of little value since they could do no more than say which party they thought should win. The latter may have further resulted in a conflict of interest since merchants doing business could also be arbitrators for disputes arising from the business. Accordingly, it has been cited that merchant arbitrators were not thought to be doing the job well which may have warranted the need for more independent court adjudication. The Privy Council established an arbitration court to handle disputes arising from policies of assurance and accordingly, over time, cases were increasingly "steered towards the Admiralty [court] rather than leaving it to the perhaps capricious decision of a group of merchants" (Ibbestson, 2008: 294).

The Privy Council also instituted a number of administrative procedures which could be regarded as regulating the London marine market (Raynes, 1948). On the 15th of June, 1575, a letter was sent by the Privy Council to the Lord Mayor of London asking him to "certify their Lordships what had been done for setting down some orders for matters of assurance…" (Raynes, 1948: 45). The Privy Council was therefore looking to codify insurance law. It is

important to understand the issues of concern and how they were addressed. Disputes arose regarding the existence and terms of insurance contracts. Furthermore, multiple policies were being taken out on the same risks. Owing to the unawareness (by certain merchants) as to the existence of these other contracts, it was possible to affect multiple policies on the same risk. Similar problems had arisen in Spain and Antwerp (Raynes, 1948). These issues are clearly market conduct type issues. As a result of these problems, it fell to the Lord Mayor to come up with some solutions. Although no full record of practices or insurance orders was given in reply to the Privy Council, it is accepted that, "a step was taken towards organizing the market therein, which had gravitated to the Royal Exchange… by making the registration of all insurances compulsory and the erection of the Office or Chamber of Assurance[20] in the Royal Exchange…" (Raynes, 1948:46; Daykin, 1992). Thus, at least three regulatory steps can be discerned as follows: i) physically, an office was established, ii) all insurance contracts were to be registered at the Office and, iii) a Registrar (Richard Candeler) was appointed to make (i.e. draft) and register insurance contracts and to oversee the functions assigned to the Office. Thus the office of Registrar was born. As such, the Office of Assurance was established to coordinate and control the writing of insurance and the registration of policies would prevent double insurance (Lewin, 1988 as cited in Daykin & Cresswell, 2001; Ford, 2011).

In February 1576, a letters patent was issued to Richard Candeler, a factor of Sir Thomas Gresham, the founding father of the Royal Exchange (Walford, 1885; Van Niekerk, 1999; Sibbert, 1997, as cited in Sullivan, 2002). The letters patent gave Candeler the exclusive right to not only register policies, but also to make them (Walford, 1885). Thus a consequence of the appointment of Candeler was the genesis of standard policy forms or wordings.

The preamble to the letters patent read:

> For as much as it is credibly given us to understand that for want of good and orderly keeping in registers the assurances made within the Realm of England among merchants… the trade of merchandise have been and yet be often times greatly abused by evil disposed people who for their private gain and advantage have assured one thing in sundry places thereby intending any loss should happen, to recover in all said places, and so often times have done, to the great loss and hindrance of divers such honest merchants as did assure the same. And the ancient custom of merchants in Lombard Street and now in the

[20] The Chamber, as its name suggests, was established during the reign of Elizabeth I (1558-1603).

> Royal Exchange by that means almost grown out of estimation which heretofore as we are informed hath been the chief foundation of all assurances.

From the above an understanding of the problems being addressed can be determined. As mentioned earlier, these include the "evils of double or over-insurance of ships and merchandise" (Raynes, 1948:46). That is, assureds were insuring the same ship several times in different places and recovering in respect of the same loss several times over (Ibbestson, 2008). The obvious remedy was the compulsory registration of policies of assurance so that underwriters could see if multiple insurance occurred and the terms and amounts of assurance placed on any insured venture (Raynes, 1948). In addition to this, and of paramount importance, was the fact that that the registration of contracts of assurance was also to record its terms for reference in cases of dispute (Walford, 1885). That is, the registration of insurance policies would document the content of insurance contracts and in the process, prevent the perpetration of fraud (van Niekerk, 1999). This step would also reduce uncertainty as to the policy terms therefore minimising disputes.

In hindsight, the letters patent appears to have been an early form of market conduct regulation in terms of policy enforcement, since the recording of the terms of assurance would attempt to ensure that merchants discharged their due obligations to the assured based on the terms of the contract. Such regulation found expression only in the letters patent granted to Candeler, since the system had no footing in legislation and accordingly, custom trumpeted the law (Ibbestson, 2008:296). Furthermore, since policies of assurance were generally being drawn by one person, over time, clauses became standardised, a notion that persists in the modern insurance arena today (Raynes, 1948).

The letters patent clearly put Candeler, economically, in a favoured position. This was something quickly understood by other interested parties who stood to lose financially as he acquired their business. The letters patent therefore was not without protest as underwriters, brokers and scriveners petitioned to the Lord Mayor alleging that such a practice would take profitable work away from them (Ibbestson, 2008). In fact, they pointed out that:

> It would also be an infringement upon the liberty of every good citizen… that it would be a great bondage to merchants to be held to one particular person who might either favour or award dispatch one man and for displeasure or ill will delay another, that merchants who intended some secret yet lawful voyage would be glad to pass their writings privately to such notaries and brokers as they know would be secret.

In response to the aforesaid opposition, Candeler voluntarily abandoned his claim for the exclusive right to draw up policies and retained only the right to register contracts of insurance (Ibbetson, 2008: 296). In one proclamation published at the Royal Exchange, it was enunciated that those policies not registered were to be null and void (Raynes, 1948). The fact that Candeler could financially benefit from the regulatory system is an early example of what later became the idea of regulatory capture. Recall, regulatory capture refers to the process in terms of which legislation could be sought and passed for those who benefit from the legislation. In this regard, Candeler stood to gain from said system as explained by the theory of regulatory capture.

5.1.1.1.1 Forum to resolve disputes and insurance law

A second problem to be addressed at this time was the establishment of an appropriate forum for dispute resolution and the identification of a set of rules and customs relating to insurance (Ibbestson, 2008). Although an arbitration court had been established, by the last quarter of the sixteenth century, the status of insurance litigation and law in London was quite problematic and uncertain and over time competing courts began to vie for the business[21] (van Niekerk, 2011: 155).

Specifically, there was no permanent tribunal for the resolution of insurance disputes. Four or even five different fora can be identified; merchants themselves, Alderman's Court, Admiralty court, Common law courts and Court of equity. The problem was further exacerbated by the fact that arbitral awards were often not obeyed and furthermore could not be enforced (van Niekerk, 1999). The latter problem is highlighted in a number of letters addressed to the Lord Mayor by the Privy Council, the last of which is dated the 30th of July 1576. Six months thereafter, London's Court of Alderman produced "certain good orders concerning matters of assurance" (Raynes, 1948:50). These documents have been described

[21] It was at this time that the King's Bench asserted that it had jurisdiction over insurance disputes arising from contracts made in England and indeed the first known common law case of *Mayne and Poyn vs De Gozi* arose in the King's Bench in 1538. Furthermore, Dr Lewis, as judge of the Admiralty Court, was desperately competing for jurisdiction of insurance disputes, whilst complaining that his court was being squeezed out by a number of prohibitions. At the same time, a number of cases were being referred to the court of Chancery. In fact, a bill was later tabled which envisaged the wholesale transfer of jurisdiction to the court of Chancery. This however never came into fruition following significant opposition since the court of Chancery was not familiar with the intricacies of insurance (see van Niekerk, 1999; Ibbetson, 2008)

as “unfinished”, “never properly finalised” and “not perfected” and as such, no author has attempted to dissect their contents.[22]

Fierce competition existed to acquire jurisdiction over insurance disputes. There was the merchant’s arbitration “court”, the Mayor’s Court of the Alderman, the Admiralty court, the Chancery with its concept of equity and the King’s Courts of Law, each with a vested interest in diverting all insurance matters to their court. In January 1577, an ordinance was passed by the Court of Alderman, which established a special court, a Commission Court, to deal with matters of insurance.[23] In terms of this Commission, seven merchants (appointed annually) were to meet twice weekly at the Office of Assurance on the west side of the Royal Exchange “to deal rightly and indifferently between party and party” (Walford, 1885:123; Ibbestson, 2008: 297). Two observations are appropriate: i) disputes were to be resolved judicially and not by a registrar, and ii) the volume of disputes must have been significant enough to warrant meeting twice a week.

The Council thereafter undertook to strengthen the jurisdiction of the Commissioners by giving them statutory authority (van Niekerk, 1999). This did not resolve the dispute of jurisdiction and in 1601, the first piece of legislation was passed involving the resolution of insurance disputes[24] (Daykin, 1992). In this matter, Dr Lewis had considerable influence. The Act of Parliament (34 Elizabeth I, c 12) sought to address only the procedural aspects of insurance disputes arising from registered policies (van Niekerk, 2011). The summary resolution set out a general or standing panel of Commissioners (often referred to as a hybrid court) to hear and determine disputes under insurance contracts, which consisted of a Judge of the Admiralty (Dr David Lewis), the Recorder, two doctors of Civil Law, two common law lawyers and “eights grave and discreet merchants” (Raynes, 1948:57). Dr Lewis, as a member of the court, once again reveals his vested interests in the court system. In addition to this, no commissioner was permitted to intermeddle in any dispute where he himself was cited a party to the matter (Raynes, 1948).

[22] These documents exist today in archival form in the shape of two lengthy and detailed, undated, handwritten manuscripts (See van Niekerk, 2011).

[23] At this time, the court was given the exclusive jurisdiction to deal with insurance disputes arising out of policies that were registered in the Chamber. This however did not put an end to the problem of competing jurisdictions since unregistered policies could be pursued elsewhere (Ibbetson, 2008).

[24] The Merchants’ Assurance Bill was in fact the first statute passed by the English Parliament that recognises the practice of insurance (Vance, 1904).

The Act of 1601 did not deal substantively with insurance law and as a result of this, insurance customs reigned supreme by the end of the sixteenth century (Martin, 2004; van Niekerk, 2011). Furthermore, there were too many holes in the legislation to make it an effective regulatory system and substantively, it achieved very little (Ibbestson, 2008:307). In other words, the 1601 Act was in its final form a compromise piece of legislation trying to appease all factions to the controversy of jurisdiction (Ibbestson, 2008; Vivian, MacGregor & van Vuuren, 2015a). Accordingly, although the Office of Assurance endeavoured to ensure appropriate policy enforcement by acting as a registration bureau, over time its existence acted as a catalyst in focusing attention on problems in the insurance market thereby enabling a more holistic approach to resolving insurance problems (van Niekerk, 1999).

Over time, the system of registration of policies was too easily by-passed and as such the Office "[was] probably much less resorted to than previously" (Walford, 1885:124; Ibbetson, 2008:307; Ford, 2011). More specifically, both the administrative and judicial functions of the Office "became first optional and finally fell into desuetude" (Raynes, 1948: 97). Furthermore, towards the end of the seventeenth century, the number of policies sold became so large that comprehensive registration of policies became increasingly impossible and as such the Office declined in importance and was eventually dissolved (Denzel, 2014). It has also been cited that the South Sea Bubble saga which resulted in the prohibition against the formation of any new companies "probably gave a final quietus to this formerly most useful institution" (Walford, 1885:124). Ibbetson (2008: 307) puts it succinctly that:

> after the squabbles of merchants, common [law] lawyers and civil lawyers – all concerned to protect their own jurisdiction against competitors – the situation in the early seventeenth century was hardly an improvement on the near-anarchy of half a century earlier.

Notwithstanding this, the establishment of the Office of Assurance marks the beginning of UK insurance regulation.

5.1.1.1.2 Comments on the regulatory position of the Elizabethan era

It can be said that the issues during this stage were market conduct in nature. The question of multiple policies was resolved by having a central place where all contracts were entered into and recorded. This was needed to protect the underwriters from fraud committed by insureds. Lloyd's would adopt a similar practice. All policies had to be entered into in the Room and

issued by the Policy Signing Office. Disputes and the enforcement of decisions were resolved via the law of contract, the rule of law and due process of law; the system advocated by Locke, as indicated above. Not even the slighted suggestion existed that a regulator could resolve these issues. The idea that a regulator can resolve disputes is a fundamental issue inherent in the market conduct regulatory system; this was absent during the Elizabethan era.

It should be noted that the personal interests of the parties responsible for the regulatory system played an important role; Sir Thomas Gresham and his factor, Richard Candeler, and Dr David Lewis all had vested personal interests in the regulatory system. All three had a vested interest in the outcomes and benefited from the regulatory system that was put into place. Recall towards the end of the Elizabethan period, the Chamber of Assurances was established at the behest of Sir Thomas Gresham and the main beneficiary was Richard Candeler who was granted the monopoly power on drafting and registering policies. Clearly Candeler benefitted from this "legislation" since he was placed in an economically favourable position. This was realised by many. Notwithstanding this, it can also be argued that the arrangement was also for the general benefit of the public since fraud was being committed against underwriters by insureds who were soliciting double insurance. It is therefore possible for regulation to be both for the benefit of individuals and in the public interest.

In recounting the history set out above, it was noted that during the Elizabethan era, state intervention endeavoured to establish which court had jurisdiction over insurance disputes. It can be argued that this was not done in the public interest but rather in response to pressure by Dr David Lewis who as mentioned earlier, was desperately competing for the jurisdiction of insurance disputes. It was also at this time that the Common Law King's Courts also wanted the business as did the Court of the Chancellery. Soon thereafter, a Bill was quickly placed before parliament which sought to give jurisdiction to Dr Lewis's court. Although there was a swift reaction against the Bill, the Act was nonetheless passed, however, a compromise was made in terms of which Dr Lewis was to be appointed as the member of the new court. It is therefore clear that this legislation was not passed solely in the interests of the public but for the interests of others. More specifically, such state intervention was an attempt to further the interests of the president of the court, Dr Lewis. He stood to gain from the regulatory system that was put into place.

The importance of this would only be partly recognised in the 1970s by Stigler as regulatory capture, as mentioned above, and academically formalised in the discipline of the economics of Public Choice by Tulloch and Buchanan, as noted earlier. The measures which were adopted during this period, despite Ibbestson's (2008) scepticism, were largely positive. It can be said of this period that the regulation benefitted both the regulators and was in the public interest.

5.1.1.2 Rise of the Lloyd's market (1688)

The regulatory system pertaining to Lloyd's is now discussed, since Lloyd's started operations after the Elizabethan Era. The Lloyd's system has been successful and continues to this day. Lloyd's thus transverses the ages. For this reason, it is convenient to deal comprehensively with the history of Lloyd's regulation at this point. It so to speak, becomes a complete story within the story. In order to understand the laws, legal arrangements and regulations governing the Lloyd's market, it is necessary to provide a brief overview of its development.

The Lloyd's market was given life in the coffee shop of Edward Lloyd in Tower Street, London in the late seventeenth century (Wright & Fayle, 1928; Gibb, 1957; Raphael, 1995). This is the age before the modern office block complex and in London, business tended to be transacted in coffee shops. The Lloyd's coffee shop was initially the meeting place for ship captains, merchants and ship owners who would exchange shipping news and intelligence (Mukherjee & Brownrigg, 2013). As mentioned above, the city of London was intent on acquiring and maintaining its standing as a leading financial market and endeavoured to be a trade centre (Raynes, 1948). As a result of this, there was an increasing demand for ship and cargo insurance (Mukherjee & Brownrigg, 2013). Accordingly, Edward Lloyd's coffee shop became the hub for wealthy merchants looking to conduct business specifically involving shipping and international trade (Lazarus, 2011). From this, one of the most important marine insurance markets was born.

In particular, merchants would instruct an office-keeper[25] to acquire insurance for a particular vessel or for a proposed voyage (Lazarus, 2011). Office-keepers who worked as the agents

[25] An office-keeper is the equivalent of the modern day broker. The term office-keeper was however preferred as the word broker had over time acquired a negative connotation. This may be owing to the fact that brokers were

for the merchants and ship-owners would approach private individuals, believed to be of reliable means, to cover a share of the risk (Lazarus, 2011). An individual would become an underwriter after accepting a line of risk (Raynes, 1950). The latter, over time, constituted the traditional Lloyd's Name. If a deal was agreed, the agreement was documented in terms of a slip where the name of the underwriter and his share of the risk was recorded, the terms for both parties were detailed and the signatures of both parties were obtained (Lazarus, 2011).

Over time, "the rise of the greater institution - Lloyd's" operated with a self-regulatory focus. This was later formalised in terms of its internal byelaws (Raynes, 1948:63; Daykin & Cresswell, 2001; Ford, 2011). It is for this reason that the history of Lloyd's supervision is unequivocally characterised by self-regulation. No insurance legislation was passed and thus no insurance regulation existed until the 1870s when the Lloyd's system of deposits was extended to the insurance market in general. It was only in 1986 at the earliest that it can be said that the UK for the first time introduced formal statutory regulatory system with the passing of the Financial Services Act (Vivian *et al.*, 2016a). When insurance legislation began to be introduced, Lloyd's however remained largely exempt from much of the legislation, since its self-regulatory system was in harmonisation with the legislation as will be discussed below (Hodgin, 1986). It was probably upon the Lloyd's system of self-regulation that the British market's self-regulatory system evolved (Davison, 1987; MacGregor, 2015).

In 1771, a formal committee, the Lloyd's Committee (which continues to this day), with certain powers of management, was formed which thereafter, by virtue of a Trust Deed Act (1811), was authorised to i) manage the affairs of its subscribers; ii) bind them to their rules and regulations and iii) subsequently require the provision of guarantees and deposits as a condition of membership (Burling, 2011: 429). The Lloyd's Act of 1871 established a committee of members, formally recognising the Lloyd's Committee, 'to have the management and superintendence of the affairs of the Society[26] and to exercise all the powers of the Society'. Said Act of 1871 empowered the Committee to make byelaws for the purposes provided in the Act, for the better execution of the Act and for the furtherance of the objectives of the Society. Further powers were conferred to the Committee by virtue of the

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often used by dishonourable traders and accordingly the term broker was associated with dishonesty and fraud (Raphael, 1995).

[26] The Lloyd's market is frequently referred to as the Society.

Lloyd's Act 1911, the Lloyd's Act 1925 and the Lloyd's Act 1951. During this time, no comparative statutory oversight mechanism existed in the broader UK corporate market (Vivian, MacGregor & van Vuuren, 2016c).

A series of Lloyd's scandals in the 1970's necessitated changes to the self-regulatory system to better regulate the market raising the spectrum of market conduct regulation and what is now known as corporate governance (Kelley, 1995). Following an inquiry, the subsequent Fisher Report (1980) precipitated the noteworthy 1982 Lloyd's Act which introduced a number of changes (Fisher Bewsey, Waters & Ovey, 2003). The Fisher Report noted that although substantial changes were needed, the Lloyd's market would be served best by "properly conducted self-regulation" and accordingly the 1982 Act endeavoured not only to maintain the system of self-regulation that traditionally governed Lloyd's and the other financial institutions in the City, but also codified the practice of self-regulation (Kelley, 1995; Lazarus, 2011:466).

The 1982 Act, among other things, established a Council of Lloyd's to define its functions (Kelley, 1925: 1935). Part of the problem was the conflict between insiders and external Names – the separation of ownership and control problem. The internal self-regulatory Lloyd's model did not cater for this. A controlling body with independent members was required. Thus the controlling body, the Council, for the first time, included independent outsiders. The duly enacted new Lloyd's Act 1982 largely institutionalised a number of the Fisher Report's key recommendations relating to misconduct which aimed to monitor performance in the market and to avert a number of threats to society (Lazarus, 2011). In particular, the Report advocated performance management and focused on preventing market abuse (Lazarus, 2011). These measures proved inadequate and a further inquiry was instituted which was followed by the Neill Report in 1987.

The self-regulatory system could not deal with the insider-outsider problem, which in any event is not an insurance problem. It is a problem common to stock exchanges which deal with insider trading. By the 1980s, much of the membership of Lloyd's, the so-called Names, were scattered across the globe; they were largely outsiders. These outsiders had little knowledge of the workings of Lloyd's with the self-regulatory structures being controlled by the insiders. Essentially, the outsiders were mere investors, providing capital to be used by the insiders; an investment problem. The market faced the investment problem, that which, as

will be seen below, was the cause of the South Sea Bubble problems. In the 1990's, Lloyd's faced a new crisis caused by long tail liability claims, liabilities which stretched over decades The institution of the individual Name, better suited to short-tail claims that are not exposed to insider trading, had outlived its usefulness and after the 1998-2001 crisis when corporate capital was introduced, its use declined. No doubt the individual Name may disappear in the future.

In 1986, the British financial services sector moved away from a system of self-regulation towards a system of 'statutory self-regulation' by virtue of the 1986 Financial Services Act which established a number of regulatory agencies and which prescribed various rules and regulations (Bernard, 1987; Gower, 1988). Sir Peter Green, the Chairman of Lloyd's at the time, argued through parliament that Lloyd's should be exempt from the 1986 Act and should remain self-regulated through its own Lloyd's Act (MacGregor, 2012). Green maintained that the Lloyd's Act would allow the people who understood the Lloyd's insurance business model to run the market as opposed to government officials who lacked such knowledge (MacGregor, 2012:81). Agreement existed on this point. As a result, Lloyd's was exempt from the 1986 Act and continued to be regulated by the 1982 Lloyd's Act but as before, in reality the difference was not that great. Thus, between the late 1980s and early 2000s "the Lloyd's market had been regulated by Lloyd's itself with only minimal external statutory oversight" (Burling, 2011: 429).

The 1986 Act however did not last long. It was repealed and replaced by the single regulator model. Following the passing of the Financial Services and Markets Act 2000 (FSMA), the Lloyd's market was brought within the scope of the Financial Services Authority's (FSA) regulatory authority, effective from the 1st of December 2001 (HM Revenue & Customs, n.d). Government was keen to bring the Lloyd's market within the purview of the FSA since it had decided that all policyholders, whether transacting through the Lloyd's market or the broader insurance market, should have the same protection under the same regulatory regime (Burling, 2011). As a result of this, the FSA would have broad powers over the Lloyd's market and its various participants. Notwithstanding this, the FSA was aware that the Lloyd's Council had a long history in terms of its regulating of the Lloyd's market and therefore believed that the Lloyd's Council was competent enough to perform a number of its regulatory duties on its behalf (HM Revenue & Customs, n.d; Financial Services Authority, n.d). Accordingly, in order to avoid duplication, the FSA would supervise the market but

delegated much of its regulatory responsibility to the Council of Lloyd's (Financial Services Authority, n.d). This was done by virtue of "Supervision Arrangements for Underwriting Agents Enforcement Co-Operation Arrangements" to ensure consistent regulation.

Originally, the FSMA 2000 established the functions of the FSA (although the FSA preceded the Act) and the memorandum of co-operation signified the means of co-operation between the FSA and Lloyd's. This co-operation arrangement was reinstated after the demise of the FSA and the formation of the Financial Conduct Authority (FCA), to be discussed in later sections, by virtue of the "FCA-Lloyd's Co-operation Arrangements". In terms of the FCA-Lloyd's Co-operation Arrangements, both parties have agreed that they will: (a) seek to dispel any confusion or misunderstanding about their different roles; (b) seek to achieve a complementary and consistent approach, so far as that is consistent with their independent roles; (c) meet and communicate regularly at appropriate levels of seniority to discuss matters of mutual interest and; (d) aim to promote efficient and effective supervision and prevent unnecessary duplication. Furthermore, Lloyd's is required to notify the regulator of "its intention to make any amendments which may alter the meaning or effect of any byelaw" (Burling, 2013: 67). Although a memorandum of co-operation exists between Lloyd's and the FCA, the Lloyd's market is therefore still largely self-regulated by its internal byelaws which are very much in line with the regulatory requirements as stipulated by the FCA (Burling, 2011). A discussion of the various Lloyd's byelaws is however beyond the scope of this research.

5.1.1.2.1 Assessment of the regulatory position of Lloyd's

It is often noted in its long history that although various syndicates faced solvency issues in the early years, there is no record of any valid insurance claim not being paid by the Lloyd's market (Raphael, 1995; Luessenhop & Mayer, 1995). These issues nonetheless would fall under the purview of prudential regulation, the first peak. In addition to this, although at various times throughout its history, Lloyd's faced "scandals", the "victims" were generally the Names whom were the providers of capital or the "investors" in Lloyd's (Raphael, 1995). These outsiders had little knowledge of the workings of Lloyd's which were controlled by the insiders (Davison, 1987). Essentially the outsiders were mere investors, providing capital to be used by the insiders. Protection of the providers of capital is a capital market regulatory

issue and not an insurance issue and it is for this reason that this need not be considered in any greater detail in this study.

As mentioned earlier, historically there has been no need for market conduct regulation since the law of contract regulated the relationship between the insurer and consumers. It was noted market conduct regulation can be destructive where it extends each parties' obligations beyond what was agreed to in contract. The near collapse of the Lloyd's market in the 1990s is illustrative of this point.

Since the Lloyd's market was at the time advised for legal purposes not to comment on their increasing losses, minimal literature exists on the various reasons for their near demise. In particular, Ian Hay Davison, as deputy Chairman and Chief Executive during this time commented in his affidavit to the High Court of Justice in 2005 that "we were told in Committee that it could not be discussed/minuted for fear of US attorneys' subpoenas to obtain the minutes for the complex litigation underway in the USA". As such, Vivian, Hutcheson, Mushai, MacGregor and Britten (2013) provide a unique explanation for the possible causes that almost brought the Lloyd's market to its knees.

Between the periods 1998 to 2001, Lloyd's suffered an accumulated loss of approximately £20 billion (Vivian *et al*., 2013). It is generally understood that one of the main sources of Lloyds' problems was the plethora of American asbestos liability claims (Vivian *et al*., 2013). Employees, alleging to have contracted an asbestos related disease, maintained that they had been exposed to asbestos in the workplace and accordingly sued employers, many of which were insured through the Lloyd's market. As a result of this, hundreds of court cases arose. The legal basis upon which these claims were founded was the Law of Tort. Initially, the Law of Torts was "conceived to deal with damage to property caused by sudden and accidental events traceable to negligent acts of specific human beings" (Vivian *et al*., 2013: 3). Notwithstanding this, the courts began to recognise liability for gradually occurring events (asbestosis)[27], something that was completely unknown at common law. As such, the early 1990s witnessed the courts reinterpreting the Law of Tort and accordingly this saw the birth of the welfare state as courts began to impose liability for social reasons rather than legal

[27] Asbestos related diseases can take between 20 to 30 years to manifest. That is, the side effects of asbestos exposure gradually show themselves over a number of years (See MacGregor, 2012).

reasons (Vivian *et al*., 2013). This concept in embedded in Lord Denning's (1979:280) socialist interpretation in terms of which he states

> In most of the cases that come before the Courts today, the parties appear at first sight to be ordinary persons or industrial companies-or public authorities. But their true identity is obscured by masks. If you lift up the mask, you will usually find the legal aid funds or an insurance company or the taxpayer- all of whom are assumed to have limitless funds. In theory the Courts do not look behind the masks. But in practice they do... That is the reason the awards of damages have escalated so as to exceed anything that even the wealthiest individual could pay. The policy behind it all is that, when severe loss is suffered by any one singly, it should be borne not by him alone, but be spread throughout the community at large.

Accordingly, courts were and may still be "increasingly seeing their role to remedy perceived social injustices; to be consumer champions" (Vivian, 2012:24). This idea is further reinforced as one judge pointed out that "public interest overrides contractual language" since companies and insurers were assumed to have deep pockets and could therefore afford to pay damages (Raphael, 1995: 198).

This issue was further compounded by the fact that the courts began to reinterpret the contract, the very instrument that was intended to set the parameters of an insurers' liability. The sanctity of the contract, an idea which supports the notion and operation of the doctrine of freedom of contract, was therefore negated. In terms of the traditional general liability policy wording, cover was provided for *accidental* losses arising from bodily injury or property damage. As stated above, such a cause of loss ought to be immediate and sudden in origin. Notwithstanding this, the courts reinterpreted contract wordings so as to allow these increasing liabilities to fall on insurers as a result of asbestos related claims; a loss which does not conform to the parameter set out above. In doing so, the courts extended coverage far beyond what was ever intended by the Lloyd's market (Raphael, 1995).

Furthermore, despite the fact that Lloyd's policies were written on an occurrence basis, US Courts later reinterpreted this to mean that claims could be made at any time in the future for accidents or exposures that occurred in the past (Raphael, 1995: 144). As a result of this, liabilities were increasingly imposed on policies which had long since been thought to have expired as the courts stated that "all periods of insurance cover were liable, from inhalation of the first harmful asbestos fibre to outbreak of the disease, often thirty years later" (Raphael, 1995: 146).

Since the courts interpreted insurance contracts to be strictly construed in favour of the injured in order to promote coverage, the Lloyd's market experienced a multitude of claims for which it had never accounted (Raphael, 1995: 145). In 1991 Lloyd's appointed the Rowland Task Force to look into the future of Lloyd's and make recommendations for long term proposals for reform (Raphael, 1995). It was at this time that David Rowland, as chairman of the Task Force and who would later replace David Coleridge as chairman of Lloyd's, commented that unless the contract is upheld, insurance becomes impossible. More specifically, it was noted that "if the courts continue to make judgements in favour of policyholders disregarding the policy wordings, then Lloyd's only needed a fairly small share of the problem to suffer extraordinary and unaffordable losses" (Raphael, 1995: 206; MacGregor, 2012: 57). The social objectives of the courts (an idea which often underpins market conduct regulation objectives) and the complete obliteration of legal logic (as embedded in the Lockean framework) meant that the Lloyd's market almost faced ruin.

In terms of the economic nature of the regulation, as mentioned earlier, the conflict of interest between insiders and outsiders, a problem that Lloyd's was ill-equipped to deal with, clearly touches on the issue of regulatory capture; the insiders benefitted from the system in place. The regulation of Lloyd's was exclusively under the control of the insiders, giving virtually no protection to the outsiders. As indicated above, the resolution of this problem belongs to the capital market and is not an insurance regulation problem and thus this is not pursued in detail in this study.

5.1.1.3 South Sea Bubble saga (1720)

Over the years, historians have described the year 1720 as the "Bubble Year" where "fantasy, panic, folly, and grotesqueness" was the order of the day (Harris, 1994: 610). This incident is often referred to when demonstrating the need for government regulatory intervention although such regulation actually accelerated the inevitable collapse (Vivian, MacGregor & van Vuuren, 2015b). Recently, for example, Wallis, JA in *Financial Services Board (FSB) v Dynamic Wealth and Others* ZASCA 2011 193 noted that "ever since the bursting of the South Sea Bubble in 1720 governments have recognised the need, in the interests of the investing public, for regulation of the financial services industry".

After having been established in 1711,[28] the South Sea Company transformed itself from a trading company into a financial institution. The latter transpired after parliament had accepted the South Sea Company's proposal to take over the British national debt in terms of which parliament would pay a 6% return on the advances made by the company (Walsh, 2014: 3). From this point onward, the "investment frenzy" began and in turn, the value of the company's stock increased by a whopping 300% just overnight (Watzlaff, 1971; Lynch, 2001).

The South Sea Company further lured investors who were captivated by the illusion of riches which the South Sea trade supposedly would generate (Wilson, 1995). Though the company's profits were over time quite modest, investor interest was preserved with false claims of prosperity, fanciful tales and rumors of South Sea riches (Colombo, 2012). The South Sea stock prices continued to rise. The rising stock prices in turn, attracted all kinds of other joint-stock companies to be launched hoping to emulate the success of the South Sea Company in attracting shareholder capital. These companies wanted to take advantage of the "booming investor demand for speculative investments" and accordingly, to cash in on the so called speculation mania (Colombo, 2012). Time soon revealed that a large majority of these companies were bogus schemes operating on a cunning *modus operandi* designed to take advantage of the credulity of investors (Cross & Prentice, 2007). Notwithstanding this, it was believed that the wave of new market entrants would compete with the South Sea Company (by diverting funds away from the South Sea Company) and accordingly, would endanger their own existence (Harris, 2000). By the 3rd of June 1720, the appreciation in the price of South Sea Company shares had started to decline and as a result, shareholders began to sell instead of buy (Vivian *et al*., 2015b).

Since a number of influential politicians had invested huge amounts of money in the South Sea venture, the 1720 Act[29] was passed by "a panic-stricken Parliament" who were concerned with alleviating the emergence of competition, hindering alternative investment opportunities

[28] The South Sea Company was formed by an Act of Parliament in 1711 to trade as a monopoly since general legislation to form companies was only passed in 1844. The latter however was not beyond criticism since the Statute of Monopolies 1623 severely curtails the English royal privilege of granting monopolies. Moreover, monopoly traders required a special Act of Parliament (see Moir, 2013).

[29] Formally known as the Royal & London Assurance Act 1720.

and in doing so, diverting capital back into South Sea shares (Wilson, 1995; Banner, 1998; Cross & Prentice, 2007). Morgan and Thomas (1962:37) note that:

> No doubt there was genuine concern among some members of Parliament about the frauds that were obviously going on, but the timing and sponsorship of the Act leave little doubt that its main purpose was not to protect the public from fraud, but to protect the Company from competition in the new issue market.

As a result of this, it is important to note that the 1720 Act was passed to "protect the South Sea's rise, and not in consequence to its fall" (Wilson, 1995:44). In other words, the 1720 Act was not passed following the collapse of the South Sea; rather it caused the collapse. The language of the Act,[30] which specifically exempts the South Sea Company from a number of its provisions, bears testament to this (Banner, 1998).

The 1720 Act, popularly known as the 'Bubble Act' from the nineteenth century onwards, was said to be a "government-created entry barrier designed to put out of business (and hinder development of) all business associations which were competing with Parliament's chartering business" (Butler, 1986: 172; Harris, 2000). That is, all companies were required to have a royal charter in order to operate, which meant that the formation of a joint-stock company was made as difficult and expensive as possible (Morgan & Thomas, 1962; Wilson, 1995). The passing of the 1720 Act meant that only two companies, the Royal Exchange Assurance and the London Assurance were permitted to carry out insurance business in England[31] (Clarke, 2011). However, this provision did not apply to any individual who if they wished to enter into business could do so on their own (Luessenhop & Mayer, 1995). That is, individual underwriters could continue at Lloyd's and because of this, it follows that the Lloyd's market was exempt from the 1720 Act. Following the passing of the 1720 Act, an order was also issued by the Lords Justices which dissolved the aforementioned 'bubble companies' who were allegedly competing for capital against the South Sea Company (Harris, 1994).

[30] The full title of the so-called 'Bubble Act' is "An Act for better securing certain Powers and Privileges, intended to be granted by His Majesty by Two Charters, for Assurance of Ships and Merchandize at Sea, and for lending Money upon Bottomry; and for restraining several extravagant and unwarrantable Practices therein mentioned."

[31] During this time however, a number of companies petitioned to Parliament for incorporation. Parliament was however reluctant to grant corporate status unless it was clear that doing so would be desirable (Morgan and Thomas, 1962).

With investors' naivety stretched to its limit and rumours of more and more people (including the directors themselves) selling off South Sea Company shares, few buyers could be found and investor confidence began to wane (Sornette, 2002). Soon thereafter, panic began to set in and share prices imploded - the metaphorical 'bubble' burst and the South Sea Company collapsed (Colombo, 2012). Public outrage prompted a number of investigations which revealed extensive fraud and accounting irregularities as well as corruption not only among company directors but also amongst politicians themselves and the highest level of government (Colombo, 2012). Because of this, consumer confidence in companies and their management was at its lowest and corporations were viewed as an instrument to defraud.

Although the 1720 Act was a panic measure, it remained on the statute books for some 105 years before it was repealed in 1825 (Wilson, 1995; Clarke, 2011). However, in terms of this repeal, incorporated companies could still not be established since no legislation existed which allowed for the formation and registration of any new companies[32] (Vivian *et al*., 2015c). As a result of this, for over a century there was very little need for extensive regulation of the financial services sector since very few business ventures were permitted to trade as the 1720 Act had long "arrested the development of the joint-stock company" (Freeman, Pearson & Taylor, 2013:640). It therefore naturally followed that without companies there was no corporate insurance market to regulate. Accordingly, by the close of the 17th Century "the insurance trade as a whole in Britain was operating entirely without any direct government supervision" (Benfield, 2013:7). By the early 1800s however, there was a rise in unincorporated trading partnerships, operating on lines similar to Lloyd's. It was clear that legislation dealing with the corporate entity could not be delayed indefinitely.

5.1.1.3.1 Comment on the regulatory position of the South Sea Bubble

The South Sea Bubble saga was essentially fraud committed against investors. Investors were induced to purchase shares with little value. This is not an insurance problem. The South Sea Bubble saga and its regulatory endeavours can be categorised partly as prudential and partly as market conduct in nature. The collapse of the company reflects the prudential aspect. The company was a financial failure which could have been detected from its financial statements. It would have been clear that no revenue income was being generated. The shares

[32] The legislation did not prohibit individuals from trading and for this reason Lloyd's continued to trade since it comprised a syndicate of individuals.

were not sold on the basis of intrinsic value but rather on the basis of its future potential. On the other hand, the market conduct aspect of the South Sea Company is apparent since the scheme was specifically designed (or quickly degenerated into) a scheme to defraud investors. In the modern sense it can be argued that market conduct is involved if investment advisers were involved and recommended the purchase of shares because of commissions they expected to gain. This aspect is not highlighted in accounts of the South Sea Bubble. Despite the fact that the South Sea saga does not appear to highlight any significant insurance market conduct issues, it is nonetheless an important development as it had an influence on the development of the Lloyd's market.

The legislative and regulatory steps were not taken in the public interest but were rather taken to protect the interests of those who were responsible for passing the legislation. Recall the large number of influential parliamentary members who stood to gain from the scheme. The legislation was being used for private purposes; it was passed largely to protect the interests of those who were responsible for passing the legislation itself. This is thus an early example of regulatory capture, in the broad sense. Over the years investment fraud has continued unabated. The South Sea saga therefore highlights the problem of regulatory capture and investment fraud which is not an insurance regulation matter.

5.1.2 Rise of the insurance corporate market in the UK (1844-1870)

The South Sea Bubble saga has a lasting impact for it was only in 1841, that a Select Committee, of the House of Commons, the Gladstone Committee, was established to investigate the state of the law insofar as it related to joint-stock companies (Morgan & Thomas, 1962). General legislation allowing the formation of new companies was thereafter passed in 1844 after which time the number of insurance companies proliferated (Wilson, 1995). Despite this however, many of the UK's most famous Victorian insurers were formed before 1844, that is, before it was legally possible to form companies.[33] There were individual trading "companies" established in terms of a Deeds of Settlement (Gower, 1953). In particular, the Rock Life Assurance Company was established in 1806, the Crown Life was founded in 1825 and the Liverpool & London & Globe was formed in 1836 (Ogborn, 1956; Thomas, 1973; Alborn, 2002). Accordingly, toward the end of the 19th century, there was a well-developed market of "companies" which was most likely modelled on the

[33] These "companies" traded as unincorporated partnerships.

syndicate structure of Lloyd's (MacGregor, 2015). However, unlike Lloyd's, there was no market regulator. It therefore follows that insofar as insurance regulation is concerned, 1844 marks the start of modern insurance market regulation (Vivian *et al*., 2015c).

The 1844 Act created the office of the Registrar of Joint Stock Companies and further provided that a company could become incorporated by a process of registration (Rix, 1945; Morgan & Thomas, 1962). Notwithstanding these provisions, from 1844 hereon until 1985, the general principles regarding the regulation of insurance companies was to leave companies virtually unfettered in the conduct of their business.

After the passing of the 1844 legislation, the decade of the 1840s and 1850s witnessed a large number of insurers entering the market, however, very few survived for long (Daykin, 1992). In fact, Stephen Cave, as vice-president of the Board of Trade, pointed out that of the 285 pure life insurance companies formed between 1843 and 1870, a mere 111 had survived by the latter date (Daykin, 1992; Ford, 2011: 253; Pearson, 2012). This was a matter of grave concern and accordingly the UK's parliament appointed a Select Committee to investigate the subject and make recommendations. It was also at this time that the question arose whether or not there should be a single piece of legislation dealing with all companies, or whether there should be least two acts; one act for general companies and a separate act for insurers and in particular life assurance companies (Vivian, MacGregor & van Vuuren, 2015d). The Report from the Select Committee on Assurance Associations (1853) favoured a separate insurance Act and in doing so summarised its views for and against special life insurance regulation. In particular, the Select Committee (1853, article VIII) noted that

> On the one hand, even admitting the general wisdom of the principle of non-interference on the part of the Government in matters of trade, it has been contended that the question of life insurance differs so materially, in its general character, from ordinary trading transactions, that it may fairly be considered as an exception to that rule.

Another major concern of the Committee related to whether there should be regulation requiring shareholders to make payment to companies[34] (Booth, 2007). At the time

[34] After companies were legally able to form in 1844, there was still an aversion to handing over capital to companies since companies were viewed as a vehicle to defraud as a result of the South Sea saga. As such, shareholders did not pay over capital to the company and similarly companies were not required to make deposits. Shareholders merely subscribed to shares and would only pay over capital if called upon to do so.

shareholders could subscribe to shares which were allocated but not paid-up. If the company was in need of capital it could make a call on shareholders. The Select Committee (1853) concluded that a compulsory amount of £10 000 of share capital ought to be paid-up.

The 1853 Select Committee clearly expressed the reason for part of the share capital to be paid up. The Committee (1853) pointed out that the payment was an integral part of the process of establishing the *bona fide* intentions of a new company and such a deposit further provided security at the early stages of a company's existence. Some while later however, the Board of Trade Committee pointed out that the primary purpose of the deposit was not, in any sense, to protect policyholders but rather to prevent speculative ventures (Booth, 2007:123). As such, it was assumed that the compulsory payment of this capital would reduce the number of short-lived start-up companies (Vivian *et al*., 2015d). Notwithstanding this, it does not appear as if too much attention was paid to the Select Committee's recommendations.

5.1.2.1 Tariff Offices

In the early 1800s and in response to slow market growth particularly in the fire market, a number of insurance companies entered into various cooperation agreements (Pearson, 2002). This saw regular price setting meetings in terms of which premium rates (referred to as tariffs) were specified and policy wordings to be used were standardised (Westall, 1998). This culminated in the establishment of the fire insurance tariff and the insurance companies which cooperated with such were referred to as Tariff Offices (Fire Offices' Committee records, 2009).

In 1868, a market organisation was established to foster co-operation and thereby administer the tariff system (Westall, 1998). It appears that a more formal market association was required to address the perceived issue that tariff rates were not being universally observed (Fire Offices' Committee records, 2009). Furthermore, there existed no statement of principles, rules or constitution on which the Tariff Offices were required to operate and accordingly, an association was required to provide clarity on this (Fire Offices' Committee

records, 2009).[35] The organisation tasked with such became known as the Fire Offices Committee (FOC).

The FOC continued to foster cooperation among Tariff Offices and in doing so, it set minimum premium rates (that were adequate to ensure market viability) and also developed model policy wordings (Pearson, 2012). This in turn, meant that product innovation, marketing and service provision became each insurer's focal point since it was only on this basis that they could compete (Pearson, 2012). This also meant that barriers of entry were raised, particularly for foreign insurers which would then require a strong understanding of the UK insurance market consumer in order to be able to compete with local offices (Pearson, 2002; Pearson, 2012).

The FOC encouraged non-tariff insurance companies to join the tariff by restricting reinsurance, underwriting and tariff information to members only (Westall, 1998). Although, the FOC never fully gained complete market control, which in itself was a point of contention, it nevertheless was an important mechanism that maintained the self-regulatory approach that had long existed in the market and enhanced the stability of the fire insurance market (Westall, 1998; Pearson, 2012). More specifically, the tariff was successful in warding off a number of insurer insolvencies. Between the 1960s and 1970s, a number of the UK insurer insolvencies occurred (Vivian *et al*., 2016c). These were largely (if not exclusively) drawn from the ranks of non-tariff companies.

As the benefits of co-operation were realised, tariff committees were formed for different classes of insurance. In particular, the Accident Offices Association (AOA) joined the FOC in 1906 (Westall, 1998). Furthermore, inter-firm cooperation and the tariff system spread beyond the bounds of the Empire. Specifically, there is no doubt that both Australia and South Africa followed the UK tariff system. The latter is discussed in succeeding sections.

Towards the end of the nineteenth century, the Lloyd's market underwent extensive expansion as it began to write non-marine classes of insurance, such as fire and accident insurance (Westall, 1998). Tariff Offices endeavoured to respond to increasing competition, however owing to the rigid nature of the tariff system, this proved difficult (Pearson, 2002).

[35] Despite this need, the FOC never had a formal constitution and only formally adopted a statement setting out its aims and objectives in 1970.

Furthermore, tariff organisations had difficulty reforming the rating structure which had undergone few changes over the decades and accordingly the tariff system was being destabilised by increasing competition (Pearson, 2002). As a result of this, the AOA abandoned its own tariff system in 1968 (Westall, 1998). Despite the expanding Lloyd's market and the rapidly increasing completion, the FOC however continued operating.

In 1972, the UK Monopolies Commission undertook an investigation of the tariff system and thereafter submitted its report to Parliament (Carter & Doherty, 1974). The tariff system, as indicated above, was in any event in decline. In particular, the Commission's mandate was to investigate whether a monopoly situation did in fact exist, and if so whether this was contrary to public interest in light of the perceived premium rate collusion (Carter & Doherty, 1974). The Commission (1972: par 395) concluded that "we see no alternative to [the] abolition of the system as a remedy" and accordingly the commission pointed out that the FOC and its tariff should be disbanded. Despite the Commission's recommendations, the FOC remained in force until 1985, after which time it was eventually terminated (Carter & Falush, 2009). The end of the tariff system has been attributed to a number of other factors. Specifically, the long run volatility and inherent instability of maintaining monopolies and therefore, the tariff agreements, has been identified as one such factor (Vivian *et al*., 2016c). Collectively these factors and the recommendations of the Commission contributed to the demise of the tariff system.

The demise of the tariff system therefore left a regulatory vacuum which was soon filled thereafter as will be discussed in later sections.

5.1.2.1.1 Comment on market conduct issues of the tariff system.

During this period, the market was self-regulated via tariff committees and it is fair to say that the tariff system governed what would be considered largely as market conduct issues. Collusion between insurers on a wide range of issues has been regarded as anti-competitive and was prohibited in the US in terms of anti-trust notions which culminated in the passing of the 1890 Sherman Act (Joskow, 1973; Wagner, 2000). Although tariff committees dealt with issues that can be classified as market conduct issues, the consumer was not the main focus of the tariff system. More specifically, albeit that colluding on prices is usually considered a

consumer issue, insurers have regarded this practice as a prudential matter to ensure that premiums are sufficiently high to reduce the risk of insolvency (Joskow, 1973).

Generally the nature of the operation of the tariff system was within the Lockean contract and the rule of law framework since their recommendations were incorporated into contract terms. Despite the fact that the tariff system's practices have rarely been regarded as market conduct issues by the industry, it was not unknown for tariff committees to issue guidelines on market conduct. For example, a guideline was issued which recommended that insurers should not exercise any subrogation rights against tenants if the tenant caused damage to the landlord's property. Since there is no clear evidence of regulatory capture, the recommendations from tariff committees to ensure that the risk of insolvency was reduced, are arguably in line with public interest objectives.

5.1.2.2 Life assurance market

It was the demise of the Albert Life Assurance Company (which after careful consideration is clearly a prudential matter) in particular, which had "greatly affected public opinion in favour of some control of life assurance" (Raynes, 1948:354; Ferguson, 1976). By the end of 1865, Albert Life had absorbed a total of twenty- six life offices, after engaging in an aggressive programme of costly mergers and acquisitions and by 1869, the stability of the company was under pressure (Walford, 1887; Raynes, 1948; Daykin, 1992). A month after an application was made for the winding up of Albert Life, a similar application was made for that of the European Assurance Society and accordingly, these two failures exposed the weaknesses of the UK's legislative structure (Daykin, 1992: 321). The opinion has been expressed that the Albert Life failed because of the large number of acquisitions and not because of its insurance business, an important factor since insurance regulation would not resolve the Albert Life issue.

A number of authors suggest that the regulation of insurance business essentially only began in earnest following the passing of the Life Assurance Act of 1870 (Daykin, 1992; Daykin & Cresswell, 2001; Ford, 2011:251). As such, given the social and commercial importance of insurance and its long history, it is notable that regulation of the industry is a relatively recent phenomenon (Noussia, 2011:34). Said legislation was largely enacted in response to life assurance firm collapses and scandals and as such governmental intervention was merely reactive, although such regulatory interference remained at a minimum (Ford, 2011:251). In

fact, the 1870 Act can be described as the mere regulation by law since the Act contains no supervisory provisions.

Legislation setting out the basic framework for life insurance regulation, was introduced to the House in 1870 by the Board of Trade and was known as the Life Assurance Companies Act of 1870 (Booth, 2007). It is important to highlight that it was the aforementioned governmental department that became the regulator of insurance firms (other than friendly societies or Lloyd's members), to the extent it can be called regulation, however the notion of "freedom with publicity" prevailed since, as mentioned above, no supervisory provisions were included in the Act (Ford, 2011). No regulator was appointed as currently understood.

A number of authors argue that the provisions of the Act can be divided into four principle heads, each of which is discussed briefly below.[36]

The Life Assurance Act of 1870 required companies to do the following:

i) *Deposits:* The Act required that all newly established life offices deposit a sum of £20,000 with the Accountant General of the Court of Chancery. A number of reasons were set forth as to why such a deposit would be desirable. The 1853 Select Committee, as mentioned earlier, emphasised that making shares partly paid-up would provide security during the early stages of the new life office. Making shares partly paid up could have the same outcome as the deposit which was paid over to a third party. The deposit could be called upon to ensure that obligations under the contracts of assurance could be fulfilled. However as noted above, the Board of Trade Committee highlighted that the requirement of making shares paid-up was rather an effort to deter any speculative ventures which were generally short lived and largely fraudulent. The deposit would reduce the large number of short-timed companies. It was speculation which had caused the South Sea Bubble.

   It is believed that the recommendation for a deposit system mirrored the longstanding Lloyd's practice (Gibb, 1957). In particular, Gibb (1957:129) noted

[36] See King (1892); Raynes (1948); Ferguson, 1976; Daykin (1992); Daykin & Cresswell (2001); Booth (2007); Ford (2011).

that “in this matter of deposits Lloyd’s was acting as a pioneer and setting an example that the British Government followed consistently when it became concerned to prevent loss by the failures of insurance companies’ holds true”.

The deposit system introduced in the 1870 Act was copied from the Lloyd’s practice. The Lloyd’s system for solvency capital developed in the late 19th century. By the late1850s, it was commonplace to ask underwriting merchants or ‘Names’ to provide security or guarantees for possible liabilities in case the syndicate faced claims requiring a call against Names (Raynes, 1948). The deposit system was therefore a type of policyholder protection tool. The deposit system replaced the original ‘surety system’ after Mr Sharp, the wealthy relative of a young man who wanted to be a Name, insisted on the payment of a cash deposit of £5 000 as opposed to the accepted method of standing surety (Gibb, 1957; MacGregor, 2015). The Lloyd’s Committee reluctantly accepted the deposit in lieu of the surety and over time this system slowly became the norm (Gibb, 1957). After 1857, it became common practice for Names to lodge a deposit of £5 000 with the Committee at Lloyd’s (Raynes, 1948). The deposit was not for solvency purposes *per se* but rather a method of obtaining assurance that the Name had some wealth to settle his liabilities (Davison, 1987).

The Lloyd’s system for solvency capital therefore precipitated the 1870 deposit requirements. This practice was thereafter merely institutionalised for the British life assurance market in terms of the 1870 Life Assurance Company Act although the reason for doing so was very different to that of Lloyd’s.

ii) *Separation of the life fund:* All newly established life offices, transacting in other lines of insurance, were required to keep a separate account for life and annuity business. This was referred to as the principle of separation of assets in terms of which the life fund could not be used for purposes other than for meeting life assurance liabilities. This requirement further prevented any contamination of the life fund as a result of financial pressures on the other general classes of insurance business.

iii) *Accounts, returns and other information for members:* The ‘life assurance fund’ was subject to actuarial evaluation and reporting in addition to a number of other

controls. Amongst other things, this included regular investigations into the financial condition of the firm (to be quinquennial for companies established after the 1870 Act, but only decennial for existing companies); the publication of annual accounts of the company, and the distribution of an abstract of the actuarial valuation. In addition to this, the 1870 Act required the furnishing of all such information of this nature to the public (and more importantly, policyholders and shareholders) which would be sufficient to facilitate an assessment of the financial position of the company. The latter gave rise to the idea of 'freedom with publicity'. That is, insurance firms maintained a good deal of business freedom provided that their affairs and financial positions were made public in such a way that it could be verified by independent actuaries and all other interested parties.

This phenomenon remained a fundamental principle in the UK's insurance regulatory system until responsibility for the regulation of insurance was assumed by the FSA. The latter is discussed in section 5.2.1.2. In addition to making such information available in the public domain, insurance firms were required to furnish a copy of such documentation to the Board of Trade. However, because of industry resistance to the Board's monitoring of annual accounts, the Board eventually conceded that its role should be less active.

iv) *Amalgamation and Winding up:* As a result of the experience of insurance insolvencies arising from imprudent amalgamations, the 1870 Act also contained provisions relating to amalgamations and insolvency. That is, amalgamations could only take place following approval from the Court of Chancery. The due process to be observed in arriving at such a sanction was set out in Section 14 of the 1870 Act. Similarly, the Courts were also to be involved in the winding up of insurance companies.

Pearson (2012: 81) points out that the 1870 Act "scarcely challenged the dominant laissez-faire principles of the British state, as it merely required the annual balance sheets of [a life office] to be audited and published and a deposit of £20,000 to be left with the Court of Chancery. The policing of companies was left to their shareholders and the insured". However, in general, there was very little dissatisfaction with the 1870 Act, although a few practical amendments were proposed (Booth, 2007). Those amendments were incorporated

in 1871 and 1872 respectively and the latest amended and consolidated Act was known as `The Life Assurance Companies Act, 1872' (Booth, 2007). This legislation however remained applicable to the life assurance industry only and accordingly, the Act did not cover general classes of insurance business (Daykin & Cresswell, 2001; Ford, 2011).

5.1.2.2.1 Analysis of the 1870 legislative changes

The 1870 Life Assurance Act was passed in response to the collapse of the Albert Life. The Act required insurance companies to deposit an amount of £20,000 with the government and to publish audited annual financial statements which were also deposited with the government (Daykin, 1992). All of these requirements concern prudential regulation. There is no indication that the legislation overtly had any market conduct objectives. There is neither a clear indication nor strong evidence of any regulatory capture. The legislation therefore appears to have been in the public interest.

5.1.3 Regulation of the insurance market (early 1900s onwards)

5.1.3.1 British Assurance Act

As mentioned above and as indicated by its name, the 1870 Life Assurance Act dealt with life assurance only, although other forms of insurance existed. In the early years of the 20th century, it was clear that other classes of insurance business, not transacting in conjunction with life assurance, should be subject to some similar form of regulation to strengthen the security of policyholders (Raynes, 1948; Carter & Falush, 2009). Supervision was extended to general insurance business following the passing of the 1907 Employer's Liability Insurance Companies Act (Daykin, 1992). Two years thereafter, Mr Churchill, then president of the Board of Trade issued a Bill in 1909 that sought to bring general insurance companies within the regulatory framework created by the Life Assurance Act (1870-1872) (Raynes, 1948; Daykin, 1992; Ford, 2011). In other words, the British Assurance Act of 1909 was indicative of the UK's decision to regulate the insurance market as a whole with a single piece of legislation. The Lloyd's market had already adopted such an holistic system prior to this and as such, the Bill was government's endeavour to follow suit. In fact, the Lloyd's experience of having two regulatory systems had revealed that this was not the correct route to go.

More specifically, by the late 19th century, the Lloyd's market was transacting in both marine and non-marine business (Dickson, 1960). However, the 1871 Lloyd's Act dealt only with marine insurance and accordingly non-marine insurance was outside the purview of the Act. For example, members of marine syndicates had to lodge a deposit of £5 000 while non-marine syndicates were not required to do so (Gibb, 1957; Vivian, MacGregor & van Vuuren, 2016a). This was particularly problematic and was brought to the forefront following the Burnard scandal in 1902. It was at that time that Cuthbert Health, "the father of modern Lloyd's" asserted that there should not be two separate regulatory systems within Lloyd's for the two distinct classes of business but rather a single system for the entire Lloyd's market (Gibb, 1957). The Lloyd's society was thus forced to re-evaluate their self-regulatory system and thereafter implemented an integrated and holistic system for the market as a whole (Gibb, 1957). The Lloyd's market would therefore be holistically managed and accordingly, a simple regulatory philosophy emerged; one market, one regulatory system. Legal Opinion was obtained which took the view that the Lloyd's Act would need to be changed to permit an holistic system and the Lloyd's Act of 1911, as mentioned above, removed the marine restriction which had existed in the 1871 Act.

One may argue that much of the regulatory steps adopted by Churchill were largely influenced by the Lloyd's model since Churchill's father-in-law was Colonel Sir Henry Hozier, who was the secretary of Lloyd's from 1874 to 1906 (Wrigley, 2002; MacGregor, 2012). Accordingly, there can be little doubt that Churchill was extensively briefed by his father-in-law about the troubles at Lloyd's and the steps taken to deal with those problems (Vivian *et al*., 2016a). The Lloyd's experience therefore illustrated the value in an integrated regulatory system.

The 1909 Act, which replaced the Life Assurance Act (1870-1872), extended the regulatory regime to include, by way of Section I, life assurance business, fire insurance business, accident insurance business, employers' liability insurance business and bond investment business[37] (Raynes, 1948; Daykin, 1992; Ford, 2011). The 1909 Act (which not only repealed the 1870 Act but also replaced the 1907 Employer's Liability Insurance Companies Act) essentially mirrored a number of the provisions contained in the Life Assurance Acts of

[37] The fundamental principle that one market be regulated by one system was therefore adopted. This would become Churchill's legacy and gift to society.

1870-1872 (Ferguson, 1976). That is, deposit requirements to the Paymaster-General, separation of funds, detailed revenue accounts and due process for amalgamations and winding-up of insurance companies were all addressed in the 1909 Act. As before, the new Act had very limited supervisory provisions (Ford, 2011).

5.1.3.1.1 Analysis of the 1909 changes

The 1909 changes were merely bringing the life and general markets into harmony. The Lloyd's experience of an holistic system had revealed that this was the correct route to go. This would become Churchill's gift to society, an ideal that appears to be forgotten in light of recent regulatory changes. The changes were arguably in the public interest since no evidence of regulatory capture is suggested.

5.1.3.2 Continued improvements

Immediately after World War II, the government endeavoured to strengthen and "plug some of the gaps" in the 1909 Act (Daykin, 1992: 331). The latter was realised through the passing of the Assurance Companies Act 1946 which continued the holistic approach to regulation and extended the 1909 Act to marine, aviation and transit insurance business (Ford, 2011: 256). Thereafter, the Insurance Companies Act of 1958, largely a consolidation of the Acts passed between 1909 and 1946, was enacted. Nevertheless, it was obvious that greater regulatory oversight would be needed in the future. It was the failure of a few high profile non-tariff insurers in the 1960s that warranted government intervention and the development of a reformed regulatory regime for the insurance market.

5.1.3.3 Impact of the failures of a number of insurers in the 1960s

More specifically, the collapse of the Fire, Auto and Marine Insurance Company (FAM) in 1966 signalled the beginning of more rigorous government control (Hodgin, 1986). In July 1966, FAM was put into liquidation as a result of plummeting underwriting returns and the systematic defrauding of over 400,000 policyholders (Massey, Hart, Widdows, Law, Bhattacharya, Hawes & Shaw, n.d). Rapid expansion, fraud, reckless management, greed, under-pricing (by virtue of premium undercutting), gross incompetence, high broker commissions and false reporting were all attributed to its demise and served to weaken public confidence in insurance companies (Day, 2000; Daykin & Cresswell, 2001; Ford, 2011;

Massey *et al*., n.d.). Although the regulator had had doubts as to the longevity of the company, it did not act (Massey *et al*., n.d). Yet again, the Board of Trade was criticised for its failure to intervene timeously and for their very circumscribed powers (Daykin, 1992).

Against this backdrop, Part II of the Companies Act of 1967 gave the Board additional powers of supervision and intervention and the Insurance Companies (Accounts and Forms) Regulations 1968 was evidence of government's more engaged approach (Ford, 2011: 257). Despite this, the lack of supervisory intervention and controls was further put to the test following the collapse of Vehicle & General (V&G) in 1971. This spurred the Insurance Companies Act of 1973 (an amended and consolidated version of its 1958 and 1967 predecessors) in terms of which additional supervisory powers were granted to the Secretary for the Department of Trade and Industry (DTI)[38] (Ford, 2011).

In response to public outrage following the collapse of FAM and V&G and particularly Nation Life (in 1974) the Policyholders Protection Act 1975 was passed[39] (Hodgin, 1986; Lee, 2001). In the insurance arena, the 1975 Act has been described as a mechanism to ensure that policyholders are financially protected and compensated, where legislation to ensure the solvency of an insurance company has failed (Birds, 2010; Merkin & Hjalmarsson, 2013). The 1975 Act has been described as playing a "suitably efficient role" in protecting policyholders (Hodgin, 1986: 51). Notwithstanding these developments, the regulatory regime remained largely reactive guided by the endemic laissez-faire sovereignty. In fact, Ford (2011:262) notes that "in the UK everything was permitted unless it was expressly prohibited". These measures were largely prudential in nature.

5.1.3.3.1 Analysis of the changes

The collapse of a number of insurers throughout the 1960s and 1970s and the legislation which followed clearly points to the growing appetite for prudential regulation during this time. On the other hand, the issue of fraud, premium undercutting, high broker commissions and the legislative responses are clearly market conduct in nature. As mentioned above, legislation that is designed to respond to various corporate failures and/or market failures

[38] In 1970 the Board of Trade merged into the new DTI.

[39] This Act was subsequently amended in 1997 and replaced with the Financial Services and Markets Act (FSMA) 2000 which provided a general compensation scheme for compensating consumers of failed financial services who are unable to pay their debts (Fisher, Bewsey, Waters & Ovey, 2003; Birds, 2010).

may be in the public interest. In light of the absence of evidence to suggest otherwise, the legislation and regulations promulgated during this time were most probably in the public interest.

5.1.3.4 Insurance Companies Act of 1982

Following the implementation of the 1973 EU Non-Life Directive (to be discussed in section 6.2) which endeavoured to create a common solvency regime, the Insurance Companies Act of 1982 (which consolidated the earlier 1974 Insurance Companies Act) was subsequently passed.[40] In particular, the prudential regulation and authorisation of insurance companies was provided for under the 1982 Act (Ferran, 2003). The 1982 Insurance Companies Act made provisions for minimum solvency margins and defined the conditions necessary in order for an insurer to be authorised to transact insurance business within the UK (Hardwick & Guirguis, 2007: 207). A discussion of said prudential requirements is beyond the scope of this study, however, in short, the object of the legislation was to: i) ensure that insurance companies maintained prescribed levels of assets over liabilities (based on a common EU definition of "margin of solvency"); ii) maintain detailed financial information which was to be made available to both the public and the Treasury and; iii) ensure that only fit and proper persons transact in insurance business (OECD, 2002: 278; Hardwick & Guirguis, 2007). Of more significance to this paper, is Section III of the 1982 Act which makes provision for the "conduct of insurance business".

According to Section 73 of the Insurance Companies Act of 1982:

> Any person who, by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by the reckless making (dishonestly or otherwise) of any statement; promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person to enter into or offer to enter into any contract of insurance with an insurance company shall be guilty of an offence.

The 1982 Act also makes provision for the regulation of insurance intermediaries. In terms of Section 74, intermediaries in any insurance transaction (who are connected to a particular

[40] At this time, banks were regulated by the Bank of England (by virtue of the Banking Act 1987) while insurance companies were subject to solvency regulation under the Insurance Companies Act of 1982 (Taylor, 2009). The Lloyd's insurance market had a special status under the Insurance Companies Act 198272 and an exemption under the Financial Services Act 1986 (Ferran, 2003: 269).

insurance company) are required to give the prospective client prescribed information with respect to his connection to that company. This might have been done to allow the buyer to assess the product and incentives of an advisor and thereby make an informed investment decision. The latter is market conduct in nature.

Despite Section III, prudential regulation (and accordingly the financial viability of an insurance firm) was largely the focus of the 1982 Act (Lowry & Rawlings, 2004). In fact, Ford (2011: 267) points out that "while the conduct of long-term insurance business was increasingly regulated under the 1986 [Financial Services] Act, prudential regulation continued to be governed by other legislation, in particular the Insurance Companies Act [of] 1982". Until this point, self-regulation was an important source of insurance practice and was until recently, the only recognised system in the UK (Birds, 2010). Notwithstanding this, the practice of self-regulation has declined over time for a number of reasons, as described below. Furthermore, in the absence of evidence that suggests otherwise, it appears that this legislation was designed to be in the public interest.

5.1.4 More recent regulatory developments

Schaefer (1990) and Ford (2011) identify three fundamental developments in the recent regulatory reform that have greatly changed the shape of financial services regulation in the UK. These fundamental developments include: i) the formation of the European Economic Community (EEC)[41] in 1957, ii) the passing of the Financial Services Act of 1986 and iii) by virtue of the passing of the Financial Services Market Act of 2000, the development of a far more sophisticated regulatory approach by both government and regulators. For continuity purposes, the narrative moves away from the chronological storytelling and continue to discuss the history of insurance legislation and regulation in the UK. In doing so and in order to fully explore these regulatory developments, a brief outline of preceding legislation is also discussed in order to provide a comprehensive historical overview. Thereafter, the account continues with a discussion of the EEC, its directives and the impact of said directives on the UK financial market.

[41] Now the European Union (EU).

5.2 Transition to regulatory bureaucratic centralism: the rise of market conduct in terms of the Financial Services Act of 1986

The 1986 Act can be best described as a "game changer". Although the changes to follow were not as a result of an identified insurance problem (but rather an investment issue, as will be explained), these changes had a direct bearing on the development of insurance regulation and thus a discussion of the 1986 Act is an important element in the narrative.

Up until 1985, the only known system in the UK was the system of self-regulation governed by the rule of law. However, following the liberalisation of the market as a result of EEC directives, the government of the day endeavoured to create a more effective regulatory system for the financial services industry. In particular, it was investment business and not insurance business that was in need of reform. Moran (1986:187) emphasised that:

> The fierceness of competition and the pace of innovation (in part around the circumvention of old established regulations) associated with this process (regulatory change) has imperilled the stability of financial systems and forced the elaboration of new rules governing prudence and honesty in the conduct of (investment) business.

As a result of this, the government enlisted the help of a leading academic lawyer and advisor to the DTI, Professor L.C.B. Gower in 1981 as part of a one man committee, to undertake a review of investor protection in the UK, particularly in the securities market (Pimlott, 1985). Professor Gower was therefore tasked with reviewing the existing regulatory structures and with making proposals for reform (Robson *et al*., 1994). In fact, the aim of review "was to consider whether the existing system of disclosure [and] regulation provides adequate protection in an efficient and economical way and, if it does not, what should be done about it" (Gower, 1984 as cited in Pimlott, 1985: 147).

Although, Gower was tasked with assessing the regulatory structures to evaluate the degree of investor protection, the commission was initially and centrally concerned with the question of "de-regulation". The idea of "de-regulation" is a strange one indeed since until 1986 the hallmark of the UK financial markets was self-regulation. That is¸ the market up to 1986 had never been regulated and accordingly, the idea of deregulation seems trite. In the centuries of its history, the UK financial market had never been regulated, and accordingly, the question arose as to what part of "de-regulation" he was concerned with. The focal point of his

attention nonetheless was the London Stock Exchange (LSE). In particular, stock brokers and investment intermediaries were his main concern.

Through their control of the exchange, both stock brokers and intermediaries imposed restrictive practices in terms of who could become a stock broker and what rate of commission could be charged. These restrictive practices were drawn up and imposed by the LSE itself on its members for the benefit of existing members, in terms of its 500 page rule book. The LSE had created an exclusive club which was difficult for outsiders to enter. Over time, there was a growing realisation that the voluntary rules of the LSE were restrictive, protecting largely the interests of the members of the exchange, as noted above.

According, the Office of Fair Trading referred the Stock Exchange rule book and certain other practices to the Restrictive Trade Practices Court, alleging that these practices were anti-competitive and therefore violated the Restrictive Trade Practices Act of 1984 (Johnson, 1992). As a result of this, the LSE decided to amend its rules lifting the restrictions. Lifting these would result in banks and other institutions acquiring ownership of brokerages ending the era of the individual stockbroker. As a result of lifting these restrictions, securities trading practices thereafter underwent considerable changes. The latter is referred to as the London Stock Exchange's "Big Bang" which was implemented on the 27th of October 1986. These changes were not owing to the passing of the 1986 Financial Services Act. This marked the arrival deregulation which was not deregulation of statutory regulation (Clemons & Weber, 1990).

It was also during this time, throughout the 1980s, that the stock price manipulation in the case of the Guinness Distillers take-over took place. This resulted in a number of criminal convictions. This problem was detected by the USA's Securities and Exchange Commission (SEC) which caused UK politicians to eye the SEC type of regulatory system with envy (Gower, 1988). Additional claims of fraud included the Johnson Matthey case (which led to the government suing a leading firm of accountants), a number of perceived scandals in the Lloyd's market and more significantly the collapse a prominent investment firm, Norton Warburg, in 1981 (Radcliffe, Cooper & Robson, 1994). The series of scandals highlighted the misalignment between the operations of the financial markets and the government's "political commitments" and accordingly, attracted considerable publicity (Radcliffe *et al*., 1994). As a

result of this, the international competitive position of London was under scrutiny owing to these perceived regulatory failures (Robson, Willmott, Cooper & Puxty, 1994).

The increasing concern with "crooks, rogues and incompetents in relation to investor protection" attributed to government's desire to ensure that foreign investors would be comfortable interacting with the London market, particularly in the light of more rigorous regulatory systems in the United States (Robson *et al*., 1994: 542). This also meant that the pervasive concept of self-regulation came under fire and the "inherent conflicts" and "operational inadequacies" of self-regulation were recognised (Ford, 2011: 265). In response to this, the government embarked on a journey to address these weaknesses and accordingly this period marked the beginning of a shift to an enhanced regulatory framework (Ford, 2011: 265). This would be done with the help of Professor Gower, who was perceived to be an authority on company law.

After publishing a Discussion Document in 1982, Professor Gower stated that the review of investor protection was being undertaken in conjunction with an analysis of the degree of protection enjoyed by persons engaged in investments other than securities (Pimlott, 1985). Thus, the review included an assessment of consumer protection measures and regulations in the insurance market, amongst others, although, as mentioned above, the thrust for the new regulatory regime had its roots in investment failures and not insurance failures. The insurance market being historically and fundamentally self-regulated was, so to speak, sucked into the new system and was neither the source nor the impetus for such reform. Accordingly, the 1986 Financial Services Act, which followed Gower's report and recommendations, was therefore not directed at a specifically identified insurance problem and for the first time in British history, a centralised bureaucratic regulatory system was born. It was as a result of the 1986 legislative changes that market conduct arose in its modern form.

The 1986 Financial Services Act emerged, receiving Royal Assent on November 7, 1986 following a number of recommendations by Professor Gower (Barnard, 1987). The mammoth 289 page Act has often been described as an enabling Act "[in] response to pressure to improve the adequacy of regulation and the inability of the financial markets to provide an impression of honesty through unsupervised self-regulation" (Robson *et al*., 1994: 541). Being an enabling Act, the detail would be contained in regulations to be published. The UK

had moved from away from self-regulation to hundreds of pages of regulations, which over the next few years would grow to more than 10 000 pages of regulations and guidelines.

The lengthy Act is entitled:

> An Act to regulate the carrying on of investment business, to make related provisions with regard to insurance business and business carried by friendly societies…to make provisions as to the disclosure of information obtained under enactments relating to fair trading, banking and insurance…[42]

Furthermore, in the Conservative Party election manifesto of 1987, it was declared that:

> The Financial Services Act of 1986 … contains stringent new powers to investigate insider dealing which was first made a criminal offence by the Conservative Government in 1980. The Conservative Party is the party of law and order. That applies just as much to City fraud as to street crime.

The provisions of the 1986 Act insofar as they relate to the insurance market are discussed below.

5.2.1.1.1 Securities and Investment Board and Self-Regulatory Organisations

In arriving at his recommendations, Gower pointed out that the existing Prevention of Fraud (Investments) Act of 1958 was no longer adequate and therefore should be replaced by more comprehensive legislation[43] (Cartwright, 1999). Gower emphasised his preference for the establishment of a number of bodies that would regulate their members, subject to government supervision (and certain conditions and carefully defined limits) and therefore the idea of self-regulation prevailed to a certain extent[44] (Peeters, 1988: 395; Radcliffe *et al*., 1994). In particular, Gower (1988:8) asserted:

> What I believed was needed was something similar to the system adopted in the United States some 50 years earlier and later copied, with modifications, by many Commonwealth and foreign countries. I wanted statutory control of investment business, widely defined, under which all those conducting that

[42] Lloyd's of London and the Banking industry are exempt from the provisions of the Act.

[43] The narrow scope of the Prevention of Fraud (Investments) Act of 1958 meant that a number of industries were exempt from its application.

[44] Gower recommended a self-regulatory system through the operation of SRO's. However, Gower was unaware of the fact that a similar system, in terms of tariff committees, had once proven to be unsuccessful and was later disbanded in the late 1970s since it was found to be unlawful.

> business would be authorised by, and regulated through, membership of a few self-regulatory organisations recognised by, and under the surveillance of, a governmental or quasi-governmental body which, ideally should be a self-standing Commission.

Professor Gower was committed to the fact that there was a need for a redistribution of responsibilities between governmental regulators and self-regulatory bodies and accordingly between statutory and non-statutory regulation (Peeters, 1988: 383). Gower (as cited in Pimlott, 1985:149) pointed out that"[i]t should be the role of government to decide major questions involving public policy but discretionary day to day regulation is better handled by self-regulatory agencies". Gower pointed out that self-regulation could be enforced more effectively since its success depends on such non-legal sanctions such as adverse publicity, suspension of listing, and expulsion from the "club" (Pimlott, 1985:148). On the contrary, the existing statutory regulation depended on criminal proceedings which required a high degree of proof and thus had a low rate of success (Pimlott, 1985:148). The idea of self-regulation was further supported by the Council for the Securities Industry who argued that government regulation inevitably results in over-detailed regulation and a rigid interpretation of rules (Black & Nobles, 1998a: 935). This was further reiterated by a number of other claims that stated that the government should avoid direct involvement in the regulation of financial services (Robson *et al*., 1994).

Following the passing of the 1986 Act, it has been cited that government had introduced a new system of “self-regulation within a statutory framework” (Bernard, 1987: 344). However, Gower (1988: 11) who was clearly an admirer of the American SEC, but who had accepted that the UK market would not at that stage accept the SEC model, points out that a more accurate description of what transpired is “statutory regulation monitored by self-regulatory organisations recognised by, and under the surveillance of, a self-standing Commission”. That is, since he realised that the UK financial market would not accept the US SEC system, he recommended a system which could be morphed into a US SEC type of system. As mentioned above, this meant that the idea of self-regulation would remain but it would be subject to the surveillance and oversight of the state, in the form of the DTI and,

more directly, the newly created Securities and Investment Board (SIB)[45] (Robson *et al*., 1994: 541).

In line with Gower's recommendations, the SIB was established as the 'designated agency', a non-statutory, private limited company, the board of which was to be appointed by the Secretary of State and the Governor of the Bank of England (Bernard, 1987; Hablutzel, 1992). However, the ultimate authority vested with the Secretary of State who could at any time resume regulatory responsibility from the SIB if it ceased to conform to the requirements set out in the legislation (Peeters, 1988). That is, although almost all the powers of regulation were vested with the DTI, powers could be delegated to the SIB to "oversee and authorise more specialist, sector-based, self-regulatory organisations (Radcliffe *et al*., 1994:613). Accordingly, in addition to issuing rules on the standards of conduct, financial supervision and protection of client money, the granting of authorisation and the monitoring of the conduct of authorised persons would be carried out by a network of self-regulatory organisations (SROs)[46] approved by the SIB (Hatchwell & Fiducia, 2009; Taylor, 2009). The SIB was therefore poised to become the centralised regulator (Vivian, MacGregor & van Vuuren, 2016b).

According to Chapter III, Section 8(1) of the Act, an SRO is a body (whether a body corporate or an unincorporated association) which regulates the carrying on of investment business of any kind by enforcing rules which are binding on persons carrying on business of that kind either because they are members of that body or because they are otherwise subject to its control. A number of criteria ought to have been satisfied before a regulatory agency was recognised. For example, a number of entrance conditions had to be satisfied to ensure that members of the regulatory agency were "fit and proper" persons (Robson *et al*., 1994). In order to receive authorisation to carry out investment and insurance business, a firm had to be a member of an SRO or had to be regulated directly by the SIB (Black & Nobles, 1998a).

[45] In addition to the establishment of SROs, Recognized Professional Bodies (RPB) were also developed. This would regulate a number of professional bodies (i.e. accountants). A further discussion of RPB's is beyond the scope of this study (see Robson *et al*., 1994 for further detail).

[46] SROs are often referred to as second-tier regulatory bodies.

Within an insurance context, the most important recognised SRO'S for the control of retail financial services were[47]:

- The Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA): for the regulation of independent financial intermediaries/advisors, including life assurance intermediaries

- The Life Assurance and Unit Trust Regulatory Organisation (LAUTRO): for the regulation of insurance companies and specifically life offices.

5.2.1.1.2 Conduct of investment and insurance business

Since the regulations which investment business will have to observe include those prescribed by the 1986 Act itself and by the secondary legislation to be promulgated by the SIB, it is therefore necessary to examine both the rules and regulations as per to the 1986 Act and in accordance with the SIB[48] (Gower, 1988: 13). It is imperative to make note of the terminology that is used in the 1986 Act. That is, the 1986 Act uses the expression "regulations" in relation to the secondary legislation made either by the Secretary of State or by the SIB (by virtue of delegation), however it is "rules" that would be made by the SRO's (as well as the SIB in addition to their "regulations") (Gower, 1988: 16). Chapter V and VI of the 1986 Act provide the framework for the regulation of financial services. As Gower (1988: 16) puts it, the 1986 Act provides the skeleton (of regulation), while the DTI, the SIB and the SROs are engaged in clothing the skeleton with flesh and muscle. More specifically, Part I, Chapter V and Part II, Section 133 of the Act, provide a framework for the regulation of the conduct of investment and insurance business respectively. In was in terms of this approach that the UK financial services sector moved from a system of regulation by law to a system of regulation by bureaucracy.

[47] The Securities Association (TSA), The Association of Futures Brokers and Dealers (AFBD) and the Investment Management Regulatory Organization (IMRO) constitute the remaining approved SROs. LAUTRO and FIMBRA were subsequently de-authorised in 1997.

[48] The main rules and regulations which the Secretary of State may make and which the SIB has had to make are: notification regulations, conduct of business rules**,** financial resources rules**,** cancellation rules**,** compensation fund rules**,** clients' money regulations **,** and unsolicited calls regulations (See Gower, 1988).

According to Section 40 (Part I, Chapter V) of the 1986 Act:

(1) Any person who-

(a) makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals any material facts ; or

(b) recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person…to enter or offer to enter into, or to refrain from entering or offering to enter into, an investment agreement or to exercise, or refrain from exercising, any rights conferred by an investment.

(2) Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.

Part II, Section 133 of the Act makes specific provision for the conduct of insurance business and reads:

(1) Any person who-

(a) makes a statement, promise or forecast which he known to be misleading, false or deceptive or dishonestly conceals any material facts ; or

(b) recklessly makes (dishonestly or otherwise) a statement, promise or forecast is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made or from whom the facts are concealed) to enter into or offer to enter into, or to refrain from entering or offering to enter into, a contract of insurance with an insurance company (not being an investment agreement) or to exercise, or refrain from exercising, any rights conferred by such a contract.

Gower (1988: 17) sums up that the rules and regulations prescribed under the 1986 Act can be divided into 5 main aims. These include:

i) To ensure that those persons undertaking investment business are “fit and proper”

ii) To ensure that authorised firms are subject to rules and regulations to safeguard client protection

iii) To provide clients with adequate channels of complaint

iv) To provide clients with the "ultimate safety net" of a compensation fund should the firm become insolvent

v) To ensure that firms are put out of business as rapidly as possible if they transgress and, if their offence is sufficiently grave, that they are prosecuted

According to Chapter V, Section 48(1) of the 1986 Act, the Secretary of State may make rules regulating the conduct of investment business by authorised persons but those rules shall not apply to members of a recognised self-regulating organisation in respect of investment business in which case they are subject to the rules of the organisation. The notion that the Secretary of State is the 'delegated authority', to which a number of functions are conferred, is emphasised throughout the 1986 Act and is further reinforced by virtue of Chapter VI of the 1986 Act. This however creates confusion as the reader may assume that the "top body" of this new regulatory structure would continue to be the DTI (Gower, 1988: 11). However section 114 subsection (1) provides that, if it appears to the Secretary of State that "a body corporate has been established which is able and willing to discharge all or any of the functions designated to which this section applies" and that certain specified requirements are satisfied, he may make an order transferring all or any of those functions to that body-which the Act describes not as a Commission, but as a "designated agency" (Gower, 1988:11).

In February 1987, the SIB officially requested that the Secretary of State acknowledge the Board as the first 'designated agency" under the Act and further to make its rulebook public (Peeters, 1988: 392). Said recognition was conferred on May 18, 1987 by virtue of Section 114(2) which states that should the aforementioned conditions be fulfilled "the body to which functions are transferred…shall be the body known as The Securities and Investments Board Limited[49] if it appears to the Secretary of State that it is able and willing to discharge them". Thereafter, the Secretary of State also delegated most, but not all, of their functions to the SIB (Gower, 1988). This included a number of "draconian powers", some of which included

[49] As permitted by paragraph 2 of Schedule 9, the SIB subsequently dropped the word "Limited" from its name.

the power to remove or suspend a firm's authorisation, the power to call for information from any authorised person, the power to investigate an authorised business as well as prosecution powers (Gower, 1988).

In addition to complying with the "statements of principle" as provided in the 1986 Act, authorised persons ought not to violate the specific 'conduct of business rules' of the SIB or of any SRO to which they are a member (Thieffry & Brooks, 1999). Accordingly, any authorised firm that is a member of a recognised SRO is not subject directly to the rules of the SIB but rather to those rules of the respective recognised (approved) SRO by virtue of their membership contract (Gower, 1988). In order to obtain approval, a SRO's rules must afford adequate consumer protection at least equivalent to those of the SIB (Bernard, 1987). In other words, the supervision of market conduct activities is entrusted with the SRO provided that they produce rule books which are at least as effective to the rule book of the SIB (Buckle & Thompson, 1998).

It was envisaged that SRO's would be subject to a three-tier rulebook structure as created by the SIB and as modelled on the provisions of the 1986 Act (Brazier, 1996). The "first-tier" contained '40 Core Conduct of Business Rules' which are detailed market conduct provisions that govern various inter-relationships (Fishman, 1991). These rules were concerned with market conduct since SROs could not set capital adequacy standards[50] (Peeters, 1988). It is the former that is of particular interest in this paper and of significance in the pursuit of tracing market conduct regulation.

It is important to note however, that under the 1986 Act, the SIB's 'Conduct of Business Rules' applied to insurance companies and friendly societies only to the extent of the marketing of policies and the management and marketing of pension funds (Peeters, 1988). In order to avoid a lengthy discussion of each SRO's specific rules, a summary of the most relevant rules to the insurance industry, as per the SIB's rulebook, are listed below. Recall, that in order to receive approval, each SRO's rules had to be of the same standard as those provided by the SIB. One could then argue that each SRO's rules would be of similar

[50] While the conduct of investment long-term insurance business was regulated under the 1986 Act, prudential regulation was largely governed by earlier legislation (including the Insurance Companies Act 1982). A number of subsequent reforms regarding prudential regulation were made. For a more comprehensive analysis of this see Ford (2011:267).

substance and accordingly any discrepancies in rulebooks would be a mere difference in semantics. That is, they will differ in form only (Gower, 1988).

The SIB's rules aimed to ensure that authorised persons and firms adhered to a high standard of integrity and fair dealing, acted with due skill, care and diligence and complied with best market practice (Barnard, 1987: 350). Following a review of Barnard (1987), Black and Nobles (1998a), Black and Nobles (1998b) and Rees and Kessner (1999), a summary of the most relevant rules to the insurance industry are listed below[51]:

- The "know your customer" rule: any person tasked with advising on or recommending a specific investment product is required to obtain sufficient and adequate information from the client concerning their personal and financial situation (as may be relevant) and investment objectives. It was however only in 1992 that guidance was given as to what the "know your customer" duties actually entailed with regards to pension business.

- The "best advice" or "best execution" rule: any person tasked with advising on or recommending a specific investment product is required to advise and recommend on those products which are most suitable for the customer and best satisfy their needs. In particular, the SIB has pointed out that the investment product recommended "must not be one which on any reasonable view the customer would be better off without" but rather that which "would plainly be more appropriate".

- Adequate record keeping: although the maintaining of adequate records was a requirement, regulators failed to convey what was meant by this and what constituted adequate record keeping. In fact, the SIB failed to prescribe any minimum length of the record keeping document and did not express the types of information that each firm was to record.[52]

- Disclosure requirements: Independent Financial Advisors (IFA) were required to disclose both their status as well as the fact that they received a commission. In other

[51] Said rules have often been described as "general rather than specific" and accordingly what they required in practice was often left to the discretion of the firms themselves (Black & Nobles, 1998b: 936).

[52] The most common method of record keeping was known as the "fact find". This was simply a popular method to "know your customer" and a mechanism to comply with the record keeping requirement.

words, sellers of insurance were required to inform prospective clients whether they were acting as an independent broker or exclusively selling the product of one company only. In addition to this, financial advisors were required to disclose any other material information and to supply "sufficient information" (rates and returns and other charges and expenses). This requirement appears to have been a reiteration of Section 74 of the Insurance Companies Act of 1982.

- Complaint requirements: firms are required to ensure that each claim was investigated and dealt with by the relevant person with appropriate experience and competence.

- Compliance procedures: each firm ought to have established compliance procedures in addition to compiling a compliance manual.

It is important to note at this point, that the Secretary of State could amend the rules of the SIB (and obviously those of an SRO) if they were contrary to any provision of the 1986 Act. In fact, Chapter III, Section 13 asserts:

> If at any time it appears to the Secretary of State that the rules of a recognised organisation do not satisfy the requirements…. [of] this Act he may, instead of revoking the recognition…direct the organisation to alter, or himself alter, its rules in such manner as he considers necessary for securing that the rules satisfy those requirements.

The aforementioned rules were not however without criticism. Regulators were often charged with failing to give adequate guidance as to what constituted "adequate record keeping" or what were the explicit duties of "know your customer" (Black & Nobles, 1998a). Pimlott (1985:149) notes that the idea of self-regulation carries with it the risks of imprecise and vague rules. The latter appears to have been the case. Notwithstanding this, the abovementioned scandals and an increasing level of international cooperation through the newly established European Community resulted in an "increased acceptance of the role of government in developing enhanced regulation and actively supervising compliance by insurers" (Daykin, 2001:2). The life of the 1986 Act and its complex structures however proved to be short lived and were replaced when the FSA was established.[53]

[53] The FSA officially opened its doors on 1 June 1998 and assumed responsibility for insurance regulation in 1999.

5.2.1.1.3 Analysis of 1986 changes

The regulatory approach ushered in by the 1986 Act marks a complete break with the past. Firstly, and as was pointed out, the changes had nothing to do with the insurance market. What was now being regulated was the 'financial market' as a whole. Thus the inexplicably restrictive practices of the London Stock Exchange and stock manipulation (a repeat of the 1720 South Sea Bubble) resulted in a generalised statutory management system being introduced which irrationally encompassed the insurance industry and other markets. The main thrust of the 1986 Act was the creation of bureaucratic institutions which developed various requirements which were clearly market conduct in nature. The age of market conduct was thus born. It should be clear that the enormous array of new obligations which were imposed on financial institutions did not arise from contract. The market conduct system therefore abandoned the Lockean system.

As indicated, the 1986 changes for the first time abandoned the UK's self-regulatory system by introducing a bureaucratic supervisory system - the centralised managerial system. The system lasted less than a decade and the collapse of Barings Bank in 1995 demonstrated its ineffectiveness. This system was thereafter replaced with an even more managerially intense system, which too was abandoned after the 2008 events. It has often been argued that legislation that is promulgated is done so in the public interest. Yet, these centralised managerial systems have clearly failed and have been enormously expensive. There is no evidence that the public had, in fact, benefitted.

5.2.1.2 Financial Services Authority and Financial Services and Markets Act 2000

It did not take long to abandon Gower's scheme as introduced by the 1986 Act. In addition to the pension mis-selling scandal (to be discussed in section 5.5.3) being one of the prominent issues that eventually "drove the overhaul of the system", the closure of the Bank of Credit and Commerce International (BCCI) and the collapse of Barings Bank in 1995 had too beckoned greater regulatory oversight (Ferran, 2012; Arnott, 2009). The collapse made it clear that the complex system created by the 1986 Act was a failure and accordingly was also the catalyst for the establishment of the FSA, to be discussed below.[54] Such "corporate

[54] The SIB was renamed the FSA and thus, technically speaking, no new regulatory body was formed. This is contrary to the belief that the FSMA 2000 created the FSA in the early 2000s. Although the FSMA 2000 spelled out the functions of and gave full effect to the FSA, the Authority had existed since 1998 prior to the passing of the Act.

collapses and malpractices within the sector suggest[ed] that, despite UK financial markets being well-developed and relatively sophisticated, there [had] been sufficient system weaknesses to enable episodes of financial company malfeasance" (Handley-Schachler, Juleff & Paton, 2007: 628).

Heffernan (2005:231) points out that both the closure of BCCI and the collapse of Barings Bank "raised questions about the supervisory abilities of the Bank of England". The Bank of England's responsibility and capabilities for regulating the banking industry thus came under fire since it appeared that Barings had enjoyed a relatively light touch regulatory regime (Taylor, 2009:70). More specifically, the Bank of England was heavily criticised for not intervening sooner to prevent the numerous BCCI fraudulent operations (Ferran, 2003: 261). The Labour Government asserted that the then 300 year old Bank of England was incapable of regulating the prudential affairs of banks and accordingly, the government of the day sought to establish a single regulator for the entire financial market (Heffernan, 2005; Taylor, 2009; Ferran, 2003).

The rationale to create a single financial regulator was based on the so-called "blurring the boundaries" argument (Taylor, 2009:73). In his statement to the House of Commons on the 20th of May 1997, Gordon Brown argued that:

> At the same time, it is clear that the distinctions between different types of financial institution-banks, securities firms and insurance companies-are becoming increasingly blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of the supervision.
>
> There is therefore a strong case in principle for bringing the regulation of banking, securities and insurance together under one roof. Firms now organise and manage their businesses on a group-wide basis. Regulators need to look at them in a consistent way. That would bring the regulatory structure closer into line with today's increasingly integrated financial markets. It would deliver more effective and efficient supervision, giving both firms and customers better value for money, and would improve the competitiveness of the sector and create a regulatory regime to genuinely meet the challenges of the 21st century.

Furthermore, a single regulator, it was argued, was in line with best international practice. After all, Norway introduced the 'single regulator' in 1986, Denmark in 1998, Sweden in 1991, Japan in 1998, Korea in 1998 and Iceland in 1999 (Briault, 2000; Davies & Green, 2008). As a result of this, some two years after the failure of Barings Bank in 1995, the

responsibility for *all* aspects of financial regulation was transferred to the FSA[55] (Heffernan, 2005). The FSA became the 'one-stop-shop financial regulator' so to speak (Vivian, 2015a). The supervisory and related powers were transferred from the Bank of England to the FSA in June 1998 in terms of the Banking Act 1998 (Ferran, 2003). The latter violated Churchill's legacy which, as mentioned earlier, endeavoured to create one holistic regulator for a single market (each with their own characteristics) and not for the financial market in its entirety.

The Financial Services and Markets Act (FSMA) 2000 (fully in effect from 1 December 2001) further completed this process of integration and signaled a shift away from self-regulation toward statutory regulation (Davies, 2001; Daykin & Cresswell, 2001). As such, the FSA was to operate under the terms of this statute as the single statutory regulator of financial services in the UK. A more comprehensive and assertive approach to regulation emerged following the passing of FSMA 2000 (Ford, 2011). The FSMA 2000, which repealed both the 1986 Act and Insurance Companies Act 1982, spelt out the both the functions and the responsibilities of the FSA. That is, the FSA's regulatory powers were derived from the FSMA 2000 although the FSA had existed prior to this time. According to Part I, Section 2(2) of the Act 2000, the regulatory objectives of the FSA are:

- Market confidence: Maintaining confidence in the financial system;
- Public awareness: Promoting public awareness of the financial system[56];
- The protection of consumers: Securing the appropriate degree of protection for consumers;
- The reduction of financial crime: Reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime.

[55] Although the Bank of England was no longer the formal prudential regulator, it continued to share the responsibility for ensuring the financial stability of the market with both the FSA and the HM Treasury in terms of a Memorandum of Understanding (see Heffernan, 2005).

[56] This objective was later replaced with a new objective of "contributing to the protection and enhancement of the UK's financial system as per the Financial Services Act 2010.

Furthermore, yet not explicitly stated in the Act 2000, the FSA was engaged in a "massive exercise to implement MiFID" into the national legislative framework (Moloney, 2014: 149). The latter is discussed in section 6.2.7.

In managing its affairs, the Authority ought to have had regard to generally accepted principles of good corporate governance. In addition to this, the FSMA 2000 provided a set of principles of good regulation that must have been adhered to by the FSA when discharging its duties. In other words, the four aforementioned objectives were "conditioned by a set of principles of good regulation" (Davies, 2001:280). Accordingly, the FSA ought to have had regard to:

- The need to use its resources in the most efficient and economic[al] way;
- The responsibilities of those who manage the affairs of authorised persons;
- The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- The desirability of facilitating innovation in connection with regulated activities;
- The international character of financial services and markets and the desirability of maintaining the competitive position of the UK;
- The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions;
- The desirability of facilitating competition between those who are subject to any form of regulation by the Authority; and
- The establishment of a consumer financial education body to facilitate consumer education in the section (this was implemented only in April 2010).

The FSA's regulatory regime was anchored on a set of principles of good practice. Under the 2000 Act, firms carrying on regulated activities are to be regulated by the FSA and are required to:

- Conduct its business with integrity
- Conduct its business with due care, skill and diligence
- Take reasonable care to organise and control its affairs responsibly and effectively (with adequate risk management systems)
- Maintain adequate financial resources
- Observe proper standards of market conduct
- Pay due regard to the interests of its customers and communicate information to them which is clear, fair and not misleading
- Manage conflicts of interest fairly
- Take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer entitled to rely upon its judgment
- Arrange adequate protection for customer's assets
- Deal with regulators in an open and cooperative way
- Disclose promptly any information relating to the firm of which the FSA would reasonably expect prompt notice.

From this it can be seen that the regulatory activities of the FSA encompassed two main areas, namely prudential regulation and market conduct regulation or regulation of conduct of business. It is the latter that is of relevance to this report. In particular, Principle 3 ('Market Practice') requires that a firm observe high standards of market conduct. It should also, to the extent endorsed for the purpose of this principle, comply with any code or standard in force from time to time and as it applies to the firm. In the end, the FSA's regulatory guidelines

amounted to a mammoth 10 500 pages - a completely unworkable and complex set of rules (Vivian, 2015c).

It was also around this time in July 2000, that the General Insurance Standards Council (GISC) was established to regulate the sales, advisory and service standards of its members (Hodgin, 2002). This voluntary regulatory body for brokers aimed to ensure that insurance customers were treated fairly by establishing a set of minimum standards of good practice (Hodgin, 2002). As mentioned earlier, prior to May 2001 when the GISC replaced the Insurance Brokers Registration Council (IBRC), brokers were to be registered under the 1977 Insurance Brokers (Registration) Act and furthermore were subject to the codes of practice and conduct as administered by the IBRC (Summer, 2013). Thereafter, the GISC, like its predecessor, established standards of conduct for brokers (modelled on the ABI codes) and further laid down a number of sanctions (Summer, 2013). According to the Code, members were required to:

- Act fairly and reasonably in their dealings with customers
- Ensure that information given to customers is clear, fair and not misleading
- Avoid conflicts of interest
- Provide sufficient information and assistance to ensure that consumers make an informed decision
- Handle claims fairly and promptly
- Ensure that all advertising and promotional material is clear, fair and not misleading
- Explain the services offered including whether or not the service is given independently
- Ensure that, as far as possible, that the products and services offered match the customers' requirements
- Explain all the main features of the products and services that offered

- Provide the customer with full details of the costs of the insurance including policy premiums, fees and charges other than the insurance premium, and the purpose of each fee or charge, and commission payments or any other amounts received for arranging the insurance

- Provide appropriate and knowledgeable advice or recommendations that are aimed at meeting the customer's interests

- Ensure that misleading claims are not made on any product or service offered or make any unfair criticisms about products and services that are offered by a competitor

Under the GISC Rules (Rule F42), insurance companies that were members thereto could not accept business from non-GISC member brokers (Burling, 2013). However, following the enactment of the 1988 Competition Act, the rule was deemed anti-competitive and accordingly, the GISC was unable to actively enforce its standards (Merkin & Steele, 2013). On 12 December 2001, Government announced the extension of FSMA 2000 to include brokers and thereby announced that the FSA would be responsible for the regulation of insurance intermediaries (Burling, 2013). The order came into force on 31 October 2004 and from 14 January 2005, virtually all insurance activities were governed by statutory regulation (Ford, 2011:273). Accordingly, GISC codes of practice were eventually replaced by the Insurance Conduct of Business' Rules (ICOB) (Summer, 2013).

5.2.1.3 Equitable Life

As mentioned above, in addition to performing 'conduct of business' supervision, the FSA was also responsible for micro-prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies (House of Lords Select Committee on Economic Affairs, 2009). As such, the responsibility for the supervision of financial stability was shared by HM Treasury[57], the Bank of England and the FSA, in what was known as the "tripartite authorities" (Hall, 2009b).

The problems of Equitable Life, which came to a head in 2000, exposed various gaps in the regulatory structure and thereafter provided considerable impetus for reform (Wheatley, 2013). More specifically, the near collapse of Equitable Life has been described as "the

[57] Formally known as Her Majesty's Treasury.

biggest crisis in the modern history of British insurance and pensions" and accordingly, has resulted in numerous reports and inquiries as to who may be to blame (Roberts, 2012:1). The crisis revealed itself in July 2000 when Equitable Life's assets were insufficient to meet liabilities and as such, it announced its closure to new business on 8 December 2000. (Jørgensen, 2004; HM Treasury, 2009). The continuation of Equitable Life was safeguarded by adjustments to its balance sheet, the sale of realisable parts of the business and the negotiation of a "compromise settlement" between itself and various policyholders in order to stabilise its business (Roberts, 2012: 7). However, by October 2008, in the wake of the collapse of the Lehman Brothers and the financial crisis, potential purchasers who were interested in acquiring Equitable's remaining 500 000 policyholders were no longer able to do so (Roberts, 2012). It was the latter that ultimately resulted in the Equitable's demise and which put the proverbial "nail in the coffin".

By this time, a significant number of reports, including the Ombudsman's report, had been published in terms of which the role of the financial regulator was interrogated. The near collapse was not caused by traditional insurance products but rather (and once again) by a pension product. At a time when interest rates were high, the Equitable sold guaranteed pensions which became unsustainable as interest rates dropped. The guarantees could only be funded over the short run from profits that were generated by other businesses. As it became more and more clear that the low interest rates would prevail for a long time, these guarantees would become unsustainable and would cause the Equitable Life to go insolvent. Accordingly, over time, it became increasingly clear that the Equitable would not be able to honour its obligations.

The only practical solution was for the Equitable Life to reduce the guarantees it had contractually agreed. Most would regard this to be a market conduct matter since the insurer had mis-sold a product. Nevertheless, in order to achieve this, the Equitable approached the courts which initially agreed to this. However, this was eventually overturned by the UK Supreme Court. More specifically, disgruntled policyholders sued the Equitable and of course won their case in the UK Supreme Court. The problem was that the insurer would never be in a position to make good on its promises and once the court made its ruling, the insurer was obviously insolvent. Insolvency is a prudential matter and thus the market conduct matter became a prudential matter. The Equitable Life soon closed its doors to new business.

Effectively it placed itself into a run off. One again, investment products had caused the problems.

The Penrose *Report of the Equitable Life Inquiry* (2004) stated that the near collapse of Equitable Life could be attributed not only to deficient non-executives, autocratic managers and an inadequate corporate governance structure, but also to the weak regulatory system (Roberts, 2012). In fact, Lord Penrose remarked that "it be appropriate to comment that the practices of the Society's management could not have been sustained over a material part of the 1990s had there been in place an appropriate regulatory structure". More specifically, the Prenrose report (2004) criticised the FSA for neglecting the numerous problems that the Equitable Life was facing. Similarly, the Baird Report (2001) pointed out a number of inadequacies in the FSA's approach to the scandal and as such, noted that prudential supervision had failed to restrain the hazardous conduct of the firm (Ryder, Griffiths & Singh, 2012). Arnott (2009), the former head of Consumer Education for the FSA, noted that "it [the FSA] was immersed in the task of ensuring that the three million people who had been mis-sold personal pensions received the compensation that was their due". As such, the FSA had failed to recognise a number of early warning signs and as a result "the scandals kept coming" (Arnott, 2009).

However, the *Baird Report (2001)* acknowledged that the Equitable Life was already headed towards failure by the time the FSA had assumed responsibility. In fact, the report (2001: 187) states:

> Applying hindsight, it is fair to say that, by 1 January 1999 [when the FSA took over], the 'die was cast' and we have seen nothing which the FSA could have done thereafter which would have mitigated, in any material way, the impact… as far as existing policyholders were concerned, or made any material beneficial difference to the financial outcome as far as Equitable Life was concerned.

Said claims were further supported by Ann Abraham, as the Parliamentary Ombudsman at the time, who noted in her report, *Equitable Life: a decade of regulatory failure (2008),* that the FSA was clear of any wrongdoing and that regulatory maladministration and a "serial regulatory failure" was to blame. This appears to be the case since the collapse of Equitable Life coincided with the formation of the then newly established FSA and as such, many of the problems associated with the Equitable transpired under the watch of the Department of Trade and Industry (DTI) and HM Treasury (Thoyts, 2010).

Following the announcement of Equitable's near failure, the FSA commissioned John Tiner (as the FSA's managing director for consumer, investment and insurance issues) "to lead a 'complete overhaul' of insurance regulation" (Roberts, 2012:10). This became known as the 'Tiner Project' which in time, adjudged the insurance regulatory system and concluded that the system as a whole was "somewhat antiquated"[58] (Roberts, 2012:10). All of the abovementioned complex changes were unable to prevent the financial failures. As a result of this, the demise of the Equitable Life gave considerable impetus for reform.[59]

5.2.1.4 Birth of Twin Peaks: the birth of the market conduct regulator

The Equitable Life's problems dated back several decades although its consequence only became clearer after the Penrose report in 2004. The problems in the financial markets became more acute with the Global Banking Crisis of 2008. The UK's manifestation of this was the collapse of Northern Rock, yet another banking crisis (as a result of the interbank loaning situation). These developments once again resulted in further regulatory changes since the Select Committee on Treasury (2008: para 9) declared that:

> The FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly.

The Tripartite authorities were thus also heavily criticised for their involvement or lack thereof in the Northern Rock experience. In fact, the House of Commons Treasury Select Committee concluded that "for a run on a bank to have occurred in the United Kingdom is unacceptable, and represents a significant failure of the Tripartite system". This failure can be attributed to the lack of emergency liquidity assistance, which traditionally would have been provided by the Bank of England (Domanski & Sushko, 2014). Since, the Bank of England had been completely divorced from the regulation of the banking industry since the early 2000s, it was therefore no longer the lender of last resort. Neither the FSA nor the Bank of England could therefore restore the financial stability of the Northern Rock.

[58] The Tiner Project coincided with the EU's Solvency II project (see Eling, Schmeiser & Schmit, 2007).

[59] This was coupled with a number of troubled financial institutions including the collapse of Independent Insurance and the failure of the Enron employee pension scheme.

In addition to this, what is clear is that the FSA established a strong consumer protection regulator at the expense of financial stability (Taylor, 2009). Arnott (2009) reiterated this point:

> [it was] clear that the FSA became the victim of regulatory capture. From the start, market confidence was the overriding objective and consumer protection was not given sufficient weight. "Light touch regulation" was the watchword, with the threat from the industry that otherwise London would lose its predominance in world financial markets. So, despite the continuing scandals, the lessons were [not] learned by the regulator, or by government, and when the FSA set up a system for regulating mortgages in 2004, yet again it was too light touch to be effective

The FSA had therefore developed a life of its own; it had morphed into a market conduct regulator. It has been suggested that the FSA's focus on market conduct was a rational response to several scandals and an ever increasing number of consumer complaints (House of Lords Select Committee on Economic Affairs, 2009). Furthermore, one can argue that since the FSA did not know how to regulate banks, in an attempt to maintain its existence, it created the market conduct regulation 'creature'. Notwithstanding this, the Northern Rock episode provided the impetus to restore some balance to the post-1997 arrangement (Taylor, 2009).

The latter was further compounded by the global financial crisis in 2008, after which time the UK's regulatory system was once again forced to reflect on itself amid numerous criticisms and controversies.[60] It was this crisis which demonstrated that the FSA was an abject failure which was woefully unprepared and incapable of managing the prudential risks of banks (Vivian, 2015c). Accordingly, the fallout from the global financial crisis achieved two regulatory outcomes, including: i) a greater scrutiny of whether firms have sufficient capital

[60] Not only did the global financial crisis result in regulatory reform in the UK but it also highlighted several weaknesses in the EU's financial regulatory architecture. In 2009, the "Larosière Report" was published which highlighted that financial supervision in Europe was "uneven and uncoordinated". Furthermore, the Report emphasised that "Remuneration and incentive schemes within financial institutions contributed to excessive risk-taking". This eventually resulted in the establishment of the European system of financial supervisors (ESFS), consisting of three European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). In addition to this, the EU sought to tackle the conflicts of interest posed by certain incentives schemes and thereby acknowledged the need for enhanced market conduct regulation (See, Financial Services Commission, 2014).

and; ii) a shift towards focusing on how transactions are undertaken and their impact on customers and wider financial markets (Norton Rose Fulbright, 2014:2). The latter indicates the UK's growing appetite for both prudential and market conduct regulation.

Since the FSA had all but ignored prudential regulation (by developing itself into a market conduct regulator), it became clear that a prudential regulator was necessary and that prudential matters should be returned to the Bank of England. On 26 July 2010, the HM Treasury published its proposal for a dual-track regulatory system[61] (Ford, 2011). According to Taylor (2009:78), the Twin Peaks proposal argued that

> The institutional structure of regulation should in future comprise two regulatory agencies, a Financial Stability Commission and a Consumer Protection Commission. The first would be responsible for ensuring the stability of the financial system as a whole, mainly through the application of prudential regulations. The second would be in charge with ensuring that firms deal with their (retail) customers in a fair and transparent manner.

As such, the FSA would be split into the Prudential Regulation Authority (PRA), a subsidiary of the Bank of England, and the Financial Conduct Authority (FCA)[62] (Stowell, 2012). As such, the FSA would cease to exist and prudential regulation would once again fall under the purview of the Bank of England. This proposal for reform was further supported by Government, who alleged that no one central authority existed for the supervision of the financial system as a whole (Ford, 2011). On the other hand, however, the FSA initially contested the proposal claiming that prudential and market conduct regulation generally dealt with similar issues and accordingly, there would be a significant and inefficient overlap between the two separate agencies (Taylor, 2009). That is, "there seemed little point in having two regulators reaching essentially duplicate judgments of broadly similar matters" (Taylor, 2009: 80). Accordingly, the FSA argued that since regulation would focus on similar fundamental issues, said issues would be best regulated by a single regulatory authority (Taylor, 2009). One cannot help but think that this is a suitable example of regulatory

[61] The Twin Peaks regulatory structure had previously been actively debated in the UK prior to the 1997 reform. The decision to create a single financial regulator was however taken in favour of the twin peak model (see Taylor, 2009).

[62] A number of name changes have been made prior to what is now known as the Financial Conduct authority. To begin with, the Consumer Protection Agency (CPA) was proposed as the regulator of market conduct issues. The CPA then became the Consumer Protection and Markets Authority (CPMA), which following the Treasury Select Committee recommendation, was eventually changed to the Financial Conduct Authority.

capture, something that the FSA had already been accused of not long before (Arnott, 2009; Taylor, 2009).

As alluded to above, the FSA was criticised for its focus on market conduct supervision at the expense of prudential regulation (House of Lords Select Committee on Economic Affairs, 2009). Lord Turner conceded that:

> Broadly speaking, [it is] true to say that in retrospect we [the FSA] focused too much on the conduct of business and not enough on prudential... the Treasury Select Committee of the House of Commons... were primarily quizzing the FSA on... Equitable Life... mis-selling of endowments, mis-selling of mortgages... so it would not be surprising if the tendency of the focus of the organisation was to thinking the external world is really worried as to whether they have a grip on conduct of business so that is what they do (Q 518).

The numerous crises discredited the FSA's claim that there were natural synergies between prudential and market conduct regulation (Taylor, 2009). In fact, the FSA may simply have been tasked with too many functions (including those of a prudential and consumer protection nature) to perform them all adequately (Taylor, 2009).

Moreover, the main argument underpinning the Twin Peaks proposal was that banking supervision should remain within the central bank as the Bank of England was lender of last resort and accordingly "the information acquired in the capacity of the bank supervisor was essential to the central bank performing the lender of last resort function" (Taylor, 2009: 84). For that reason, the best arrangement was for the lender of last resort and the banking supervisor to be located in the same institution (Taylor, 2009). Proponents of the dual track system recognised this argument, particularly after the collapse of the Northern Rock. More specifically, Professor Willem Buiter as expert witness to the House of Commons Treasury Select Committee, argued that

> The notion that the institution that has the knowledge of the individual banks that may or may not be in trouble would be a different institution from the one that has the money, the resources, to act upon the observation that a particular bank needs lender of last resort support is risky.

On 1 April 2013, the proposal for reform was realised and the UK's regulatory system adopted the "twin-peaks" regulation model, in terms of which the "one size fits all" approach of the FSA was abandoned in favour of two more specialised bodies or 'centres of expertise' (Hodgson & Baker, 2011). The latter was achieved following the passing of the Financial

Services Act 2012 in terms of which both the PRA and the FCA came into existence. In terms of this arrangement, the PRA is responsible for the micro-prudential regulation of banks, insurance companies and investment firms (the Bank of England is responsible for macro-prudential regulation)[63] while the FCA is responsible for the conduct of business and market functions of all financial institutions (Stowell, 2012). In addition to market conduct functions, the FCA is also responsible for the prudential regulation of around 24 500 firms that are not regulated by the PRA, one of which includes insurance intermediaries (Hodgson & Baker, 2011). The Financial Services Bill, which received Royal Assent in December 2012, specified the FCA's statutory objectives and its statutory principles of good regulation (McMeel, 2013:606).

According to its mandate, the FCA has a number of operational objectives in terms of which it should:

- Secure an appropriate degree of protection for consumers (the consumer protection objective);
- Promote effective competition in the interests of consumers in financial markets (the competition objective); and
- Protect and enhance the integrity of the UK's financial system (the integrity objective).

The details of the regime are contained in secondary legislation and rules (Ferran, 2003:276). The latter is discussed in the section below.

5.2.1.4.1 Core conduct of business rules

Market conduct or conduct of business rules, refer to the rules that govern how various aspects of a business or firm should be conducted (Smethurst *et al*., 2011). Since the UK refers to said rules with the use of the 'conduct of business' title, this section does the same although the terminology 'market conduct' has been referred to in earlier sections. Conduct of business rules are generally designed for the benefit of the retail consumer and accordingly

[63] The Bank of England was given formal statutory responsibility for financial stability under the Banking Act of 2009 (see Taylor, 2009).

may restrict the operation of some rules (derived from insurance contract law) which are often described as favouring the insurers and not policyholders (Smethurst *et al*., 2011: 358).

Over the years, market conduct rules in the UK have been amended and as such, a number of earlier sourcebooks have been revoked. Most recently, the UK's Conduct of Business Sourcebook of 2001 (COB) was replaced with the New Conduct of Business Sourcebook (COBS) which took effect on 1 November 2007 and is still applied today. Although COBS covers "broadly the same material" as the old COB sourcebook, it implements a number of provisions, principles and rules as set out in EU MiFID[64] (Financial Conduct Authority, 2014a). In other words, MiFID provisions have been enshrined in the UK's conduct of business rules and regulations. Because of this, there is considerable overlap between MiFID provisions and existing 'Conduct of Business' and 'Insurance Conduct of Business' Rules (ICOB) (Field Fisher Waterhouse, 2007). For that reason, and in order to avoid lengthy repetition, a brief overview of a collection of conduct of business rules, applicable to the insurance industry and as imposed by the current FCA, are discussed below:

i) *Act honestly, fairly and professionally:* A firm must act honestly, fairly and professionally in accordance with the best interests of its client ("The client's best interests rule").

ii) *Act with integrity, skill, care and diligence:* A firm is required to act with integrity, skill, care and diligence ("The customers' interests rule").

iii) *Material Interest:* Where a firm has a material interest in a transaction to be entered into with or for a customer, the firm must take reasonable steps to ensure fair treatment for that customer and as such, manage any such conflicts of interest in a fair manner.

iv) *Disclose information before providing services:* A firm must provide appropriate information in a comprehensible form to a client about the firm and its services, its investment strategies, including appropriate guidance on and warnings of the risks associated with such investments, the complexity of its products, as well as the costs and other associated charges. In doing so, this should allow a client to be able to reasonably understand the nature and risks of the service and of the

[64] In addition to this, current conduct standards incorporate a number of other rules which have been inherited from a various codes of conduct of the ABI and former SRO's (see Norton Rose Fulbright, 2014).

specific type of investment/product that is being offered and, consequently, to make (investment) decisions on an informed basis.

v) *Inducements:* A firm must take reasonable steps to ensure that neither it nor any of its agents offer, give, nor solicit, any inducement which is likely to significantly conflict with any duties owed to its customers.

vi) *Fair and Clear Communication:* A firm may make a communication with another person which is designed to promote its services only if it can show that it believes on reasonable grounds that the communication is fair and not misleading. Furthermore, a firm must take reasonable steps to ensure that any agreement, written communication, notification or information which it gives or sends to a customer to whom it provides investment services, is presented fairly and clearly.

vii) *Advertising and Marketing:* Where a firm issues or approves an investment advertisement, it must apply appropriate expertise and be able to show that it believes on reasonable grounds that the advertisement is fair and not misleading. Furthermore, a firm must refrain from "cold calling".

viii) *Information about the firm:* A firm must take reasonable steps to ensure that a customer to whom it provides its services is given adequate information about its identity and business address, the identity and status of other relevant agents with whom the customer has contact, the identity of the firm's regulator and the compensation scheme in which the firm is a member.

ix) *Insurance Intermediary:* A firm which acts as an independent intermediary must act independently and exclusively for one insurer whenever it advises customers on product packages. Furthermore, if an insurance intermediary informs a customer that it gives advice on the basis of a fair analysis, it must give that advice on the basis of an analysis of a sufficiently large number of contracts of insurance available in the market to enable it to make a recommendation regarding which contract of insurance would be adequate to meet the customer's needs.

x) *Commission Payments and Fee Disclosures:* A firm may only deal through a broker pursuant to a soft commission agreement provided that the broker has agreed to provide best execution to the customer and adequate prior disclosure is made. That is, a firm must provide its customer with details of the amount of any fees other than premium monies for an insurance mediation activity. The details must be given before the customer incurs liability to pay the fee, or before

conclusion of the contract, whichever is earlier. This is often referred to as the 'disclosure regime'.

xi) *Appointed representatives:* A firm must satisfy itself on reasonable grounds and on a continuing basis that any appointed representative is fit and proper to act for it in that capacity.

xii) *Suitability of Advice:* A firm must take reasonable care to ensure the suitability of its advice for any customer who is entitled to rely upon its judgment. In doing so, a firm must: (1) establish the customer's demands and needs by using information readily available to the firm and by obtaining further relevant information from the customer, including details of existing insurance cover; (2) take reasonable steps to establish whether a policy is suitable for the customer's demands and needs, taking into account its level of cover and cost, and relevant exclusions, excesses, limitations, and conditions; (3) inform the customer of any demands and needs that are not met; and (4) explain to the customer its recommendation and the reasons for the recommendation.

xiii) *Assessing Appropriateness:* Similar to the 'suitability of advice' requirement discussed above, a firm is obligated to ask the client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the firm to assess whether the service or product envisaged is appropriate for the client. Moreover, when assessing appropriateness, a firm must determine whether the client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or service offered or demanded. Thereafter, a firm should take reasonable steps to ensure that a customer only buys a policy under which he is eligible to claim benefits. If, at any time while arranging a policy, a firm finds that parts of the cover apply, but others do not, it should inform the customer so he can take an informed decision on whether to buy the policy. Furthermore, a firm must make a record of the eligibility assessment and, if the customer proceeds with the arrangements proposed, retain it for a minimum period of three years from the date on which the assessment was undertaken.

xiv) *Best Execution:* Firms must take all reasonable steps to obtain, when executing orders, the best possible result for its clients, taking into account the execution factors, including price, speed and any other direct or indirect costs. Furthermore,

when a firm is authorised to execute orders on behalf of clients it must do so in a prompt, fair and expeditious manner.

xv) *Claims Handling:* Firms are required to handle claims fairly and promptly and in accordance with the FSA's Dispute Resolution: Complaints (DISP) sourcebook. Where firms have failed to do so, customers may refer their claims to the Financial Ombudsman Service (FOS) which was established in 2000 to provide a cost effective and informal mechanism for dispute resolution.

In summary, and according to Smethurst *et al*. (2011: 357), conduct of business rules are generally restricted to pre-contractual matters, and cover the following matters:

- The marketing and advertising of insurance products
- The provision of information by a firm to a prospective insured during the sales process
- The suitability of advice
- The potential conflicts of interest that may arise
- The record keeping requirements
- The claims and complaint handling process

Conduct of business rules are legally binding on those firms authorised by the FCA to carry out their business (Smethurst *et al*., 2011). Breaches of these rules may attract penalties (both financial and public censure) for undesirable practices and those persons who suffer loss as a result of the contravention, may sue for damages under section 150 of FSMA 2000 (Smethurst *et al*., 2011: 386).

It was also at this time that the IAIS published the "Insurance Core Principles, Standards, Guidance and Assessment Methodology" (as amended in 2013). According to ICP19 ("Conduct of Business") insurers and intermediaries are required to:

- Act with due skill, care and diligence when dealing with customers;
- Establish and implement policies and procedures on the fair treatment of customers;

- Take into account the interests of different types of customers when developing and marketing insurance products;
- Promote products and services in a manner that is clear, fair and not misleading;
- Satisfy various timing, delivery, and content of information requirements;
- Provide appropriate advice, taking into account the customer's disclosed circumstances;
- Ensure that any potential conflicts of interest are properly managed;
- Handle claims in a timely and fair manner;
- Handle complaints in a timely and fair manner; and
- Protect private information on customers.

Although greater regulation has resulted in an increase in the cost of compliance to the industry, a number of firms have welcomed the regulation where it has reassured customers and in doing so, has encouraged further investment activity (Lowry & Rawlings, 2004). In other words, Ford (2011:265) argues that although insurers had previously seen regulation as a barrier to entry, the industry has begun to press for better regulation as this could enhance their reputations and put them at the centre of the global financial market. The new financial regulatory regime coincided with other initiatives affecting the insurance industry, one of which included preparations for the Retail Distribution Review (RDR) (Hodgson & Baker, 2011). In fact, the FCA was required to "build on the progress recently made by the FSA towards a more interventionist and pre-emptive approach to retail conduct regulation. As a starting point… it will continue with initiatives such as the Retail Distribution Review" (HM Treasury, 2010: 34).

5.2.1.5 Retail Distribution Review (RDR)

Since the mid-1980's, the UK has addressed mis-selling and improper advice with a number of different approaches. These included various "best interest" requirements and disclosure regimes, as discussed above (Niemeyer & Thorun, 2012). However, said requirements failed

to prevent other major mis-selling scandals, including the endowment (mortgage) mis-selling scandal and payment protection insurance ("PPI") mis-selling scandal in the early 21st century (McMeel, 2013). As a result of this, financial regulators recognised the dangers of commission payments (Niemeyer & Thorun, 2012). More specifically, in 2002, the FSA expressed its concerns over incentive payments and remuneration structures and as such, proposed several improvements (Niemeyer & Thorun, 2012). Similarly, the Treasury Select Committee (2004) asserted that the long-term savings industry was "wedded to an inappropriate sales and commission led business model which [was] damaging the reputation of the industry and undermining consumer confidence in long-term saving". Furthermore the Committee (2004) emphasised that:

> Action is needed to better align consumer and product provider interests in the area of financial services. The current commission structure within the industry rewards potentially inappropriate and short-term sales practices. Sometimes this is at the expense of the saver's long term interests. It is unacceptable that the industry's current commission structures rewards the industry irrespective of the investment performance of the products it sells.

Results from an enquiry into the adopted 'disclosure regime' found that there had been "little evidence that the [disclosure regime had] had a significant effect on the market" (CRA International, 2007: 4). Furthermore, it was found that "investors find it difficult to decode labels and [did] not equate commission payments, even with specific disclosure, with potential prejudice to the independence of advice" (Moloney, 2010: 268). As such, the system was criticised for not only rewarding quantity of business over quality of business, but also for creating product bias, unsuitable sales and unncessary commissions and fees (Niemeyer & Thorun, 2012).

In response to the aformentioned criticisms, the Retail Distribution Review (RDR) was rolled out, effective from 31 Decmber 2012 (Galbiati & Soramäki, 2014). The RDR provisions intend to improved the quality and suitability of advice given by prohibiting product-provider commission payments and further seeks to address conflicts of interest and perverse incentives[65] (Andenas & H-Y Chiu, 2014). According to Brown and Rice (2012: 579) and

[65] In addition to improving the transparency of charges and services offered and removing commission payments to advisers, the RDR rules have further raised the minimum level of adviser qualifications (Financial Conduct Authority, 2014b).

Niemeyer and Thorun (2012:54), in terms of the RDR rules, firms that offer financial advice to retail clients will have to:

- Design and create their own charging structures and communicate them with their clients before providing any advice. This should be done using a price list of tariffs and agreement should be reached between themselves and their prospective client. Furthermore, financial advisors will no longer be unable to receive commission payments from product providers. The latter aims to prevent advisors from being biased by the amount of commission payments and in doing so, endeavours to prevent advisors from promoting one product over another to the detriment of the consumer.

- Describe their services as either “independent” or “restricted”.

- Meet high standards of professionalism and expertise through recognised qualifications and codes of ethics.

Following the implementation of the RDR, a number of significant new rules are found in COBS 6.1A in terms of which a firm that makes a personal recommendation to a retail client in relation to an investment product ought to comply. In particular, COBS 6.1A.4R provides that a firm must:

1. only be remunerated for the personal recommendation (and any other related services provided by the firm) by adviser charges; and

2. not solicit or accept (and ensure that none of its associates solicits or accepts) any other commissions, remuneration or benefit of any kind in relation to the personal recommendation or any other related service, regardless of whether it intends to refund the payments or pass the benefits on to the retail client; and

3. not solicit or accept (and ensure that none of its associates solicits or accepts) adviser charges in relation to the retail client's retail investment product which are paid out or advanced by another party over a materially different time period, or on a materially different basis, from that in or on which the adviser charges are recovered from the retail client.

As mentioned above, RDR rules and provisions have attempted to enhance the quality and suitability of advice by imposing a ban on product-provider commission payments. As such, COBS 6.1B. 5R asserts that a firm must not offer or pay (and must ensure that none of its associates offers or pays) any commissions, remuneration or benefit of any kind to another firm, or to any other third party for the benefit of that firm, in relation to a personal recommendation (or any related services), except those that facilitate the payment of adviser charges from a retail client's investments in accordance with this section.

The FCA has acknowledged that RDR rules are likely to be compatible with the impending EU Markets in Financial Instruments Directive II, to be discussed below (Rice, 2012). However, whereas RDR rules prohibit all commission payments made to advisers by anyone other than their clients, the final MiFID II proposals will most likely only create an improved 'disclosure regime' and are likely to impose a ban on third party payments to "independent" advisers only (Brown & Rice, 2012: 579).

The impact of MiFID II on the UK's RDR rules and provisions will presumably only reveal itself when the new Directive is transposed into the UK's legislative framework. However, the impact of the MiFID II on RDR rules may become obsolete as the Financial Advice Market Review (FAMR) is considering radical reforms to regulation which may roll back key aspects of the current RDR in order to boost access to advice (Selby & Sands, 2016: para 1). In particular, in August 2015 the Government appointed a panel of experts (jointly led by the Treasury and the FCA) to assess the current regulatory and legal frameworks governing the provision of financial advice and to develop reform proposals[66] (Financial Conduct Authority, 2015). The review is said to tackle the advice gap that is arguably more prevalent amongst the lower end of the market (HM Treasury, 2015). This may suggest that policymakers are eager to pursue changes which could potentially undermine RDR rules and regulations and this in itself may suggest the Governments' uncertainty regarding its experimentation with RDR (Selby & Sands, 2016). This in itself may indicate that RDR is not in the public interest. Notwithstanding this, however, at present RDR rules and provisions continue to regulate the market.

[66] Some potential proposals may include i) reducing the qualification requirement for advisers selling basic products, ii) developing a new charging structure similar to the former commission system and iii) banning regulated advisers from selling unregulated products (See Selby & Sands, 2016).

5.3 British Intermediaries Market

5.3.1 Regulation of insurance intermediaries

Up to this point, government intervention was concerned mostly with the financial stability of a firm and the various reactive mechanisms for insurance firm failures. However, control and supervision of intermediaries eventually came within the purview of government and accordingly formed part of the overall policyholder protection package (Hodgin, 1986). In 1977, the Insurance Brokers (Registration) Act 1977 was passed. This was not surprising since commission hungry agents who, in many cases, lacked the ability to market products effectively and efficiently, were said to have contributed to many of the failures discussed above (Lowry & Rawlings, 2004). Although government had recognised the need for increased supervision in this regard, the regime remained largely self-regulated (Hodgin, 1986). The British Insurance Council (a collection of various broker's organisations) and the Insurance Brokers Registration Council (IBRC)[67] (a non-statutory and independent organisation) collectively promulgated a series of codes of practice and enforced regulation amongst the fraternity (Jess, 2011).

Registered brokers were required to comply with a code of conduct, maintain professional indemnity insurance, establish a complaints procedure and compensate affected policyholders as a result of a broker's negligent action (Ford, 2011: 261). Wang (2003: 91) points out that the conduct of such an intermediary was subject to the principles of the Code of Conduct. As such, this indicates the existence of a legislated form of conduct regulation, although it was enforced by non-statutory, independent organisations on a self-regulatory basis.

The code of conduct contained a number of guidelines, some of which read as follows:

> Insurance brokers shall at all times conduct their business with utmost good faith and integrity… they shall do everything possible to satisfy the insurance requirements of their clients and shall place the interests of those clients before all other considerations. Subject to those requirements and interests, insurance brokers shall have proper regard for others… statements made by or on behalf of insurance brokers when advertising shall not be extravagant or misleading.

The 1977 Act, which was subsequently repealed by the Financial Services and Markets Act (FSMA) 2000, was followed by the 1982 Insurance Companies Act (restricted to general

[67] This was subsequently replaced by the General Insurance Standards Council under FSMA 2000 (see below).

insurance business) and the Financial Services Act of 1986 (applicable to long term insurance contracts) (Lowry & Rawlings, 2004). According to Lindell (1998 as cited in Beveridge, 2001:11), the 1977 Act was repealed after consultations with Government led to the conclusion that the

> case for continuing statutory regulation of insurance brokers has not been made ... it no longer fully meets the needs of today's market… to maintain and improve professional standards in the transaction of non-life insurance business (such as car and house insurance) by brokers and other intermediaries, the Treasury will look to voluntary self-discipline rather than statute.

Accordingly, it was decided that statutory regulation was unnecessary and a better system would be one of self-regulation by a body that was independent of insurers and intermediaries and who would take into account the interests of industry players and their customers (Beveridge, 2001). The latter may indicate the applicability of the public interest theory as an explanation for such regulation.

5.4 British Friendly Societies

5.4.1 Regulation of friendly societies

Just after the Life Assurance Act was passed, the UK parliament turned its attention to Friendly Societies. It is appropriate to deal with this aspect as an interlude. Friendly societies were subject to minimal regulation under the 1793 Friendly Societies Act (the Rose Act 'for the Encouragement and Relief of Friendly Societies') since Government interference in an open market was unheard of and not thought of (Macnicol, 1998; Ford, 2011). In fact, Daykin (1992: 316) asserts that although "members of Parliament were concerned about the possibilities for abuse and saw the need for some protection for policyholders, the government of the day did not want to restrain free trade". However, legislation passed since 1793 contained gradual increases in regulatory control and requirements[68] (Gilchrist & Moore, 2007:176). This appears to have been in response to "the wholesale error, deception,

[68] A total of 19 Acts regulating friendly societies were passed between 1793 and 1875. Between 1793 and 1830, legislation was passed for the sole purpose of encouraging the development of friendly societies in order to relieve some of the "public burthens" on the state in terms of poor relief. Thereafter, concern over the financial stability and management of friendly societies became the prerogative of parliamentary committees. The Friendly Societies Act 1992 was subsequently repealed (See Gosden, 1961: 173-174).

fraud and swindling, which [were] perpetrated upon the most helpless portion of the community, who [found] themselves without defence" (Dennett, 1998: 59).

Members of Prime Minister William Ewart Gladstone's administration (1868-1874) had long been concerned with the mismanagement of friendly societies and reflected on those 'nefarious' societies who recruited highly paid agents to go door to door to recruit, and often harass, members who could ill-afford such premiums (Gilchrist & Moore, 2007:173). The latter eventually led to the formation of the Industrial Life Offices Association[69] the forerunner of the LOAA, after co-operative action was taken (Gilchrist & Moore, 2007:173). However, the Association only came into being formally in 1901, and as such, it would be erroneous to discuss this point any further.

Of utmost importance was the passing of the 1875 Friendly Societies Act following the recommendations of a Royal Commission as a result of ongoing concerns regarding inadequate premiums and mismanagement of friendly societies, amongst other things (Ford, 2011: 253). The 1875 Act not only consolidated earlier legislation regarding friendly societies, but also sought to alter the previously existing law in numerous important particulars (Holdsworth, 1875:7). The following extract appears in Holdsworth's (1875) 'Friendly Societies Act, 1875 with Explanatory Introduction and Notes':

> While it [the 1875 Friendly Societies Act] affords additional facilities for the formation of these societies and the conduct of their business, it is also intended to furnish securities against improvident management; and to prevent the wasteful dissipation of funds, the arrangement of contributions on a basis inadequate to the realisation of the benefits promised, or the pursuit of unfair and unjust conduct on the part of the managers of a society towards any of its members.

The political action enunciated above was driven by the general dissatisfaction with the way in which friendly societies were operating (Gilchrist & Moore, 2007). The Act of 1875 not only introduced specific audit, solvency, management and financial reporting requirements[70],

[69] The Industrial Life Offices Association was founded in 1901 amid concerns that agents were 'poaching' clients from one company to another for commission purposes. In 1940, the Association underwent a name change and was thereafter referred to as the Industrial Life Offices Association. The association ceased to exist in 1985 when its functions were delegated to the Association of British Insurers (ABI) (See London Metropolitan Archives, 2011).

[70] In 1867, the Registrar of Friendly Societies estimated that since 1793, 36 per cent of societies formed had subsequently collapsed. This was said to have been the result of recurring financial difficulties, competition

likened to modern prudential regulation principles, but also by way of Section 30 of the Act, developed a number of provisions that governed the interrelationship between members and societies (Campbell, 1911; Gilchrist & Moore, 2007:180). That is, the 1875 Act not only imposed a number of requirements that set out to govern the formation and operation of friendly societies but also, and more notably, addressed issues of mismanagement of funds and the unfair treatment of policyholders (Ford, 2011:253). It is the latter that is of particular significance in the quest to track the evolution of market conduct regulation.

In particular, policy lapses, forfeiture, and the winding up and merging of societies were all of special importance. In fact, Gladstone had commented that a policyholder had no control over his policy when it passed from hand to hand in the case of a merger (Dennett, 1998). In order to remedy the aforementioned problems, Section 30 of the 1875 Act required the delivery of proper notice before forfeiture and further limited the freedom of the offices to transfer policyholders from one insurer to another without proper consultation (Morrah, 1955:58).

Section 30(2) and (3) read as follows:

> No forfeiture is incurred by any member or person insured by reason of any default in paying any contribution, until after a written or printed notice has been delivered or sent by post prepaid to him, or left at his last known place of abode, by or on behalf of the society, stating the amount due by him, and apprizing him that in case of default of payment by him within a reasonable time, not being less than fourteen days, and at a place, to be specified in such notice, his interest or benefit will be forfeited, and after default has been made by him in paying his contribution in accordance with such notice.
>
> No transfers without written consent. No member of or person insured with any society can unless in the case of an amalgamation, transfer of engagements, or conversion into a company under section twenty-four of this Act, or as respects an industrial assurance company of an amalgamation or transfer of business under the Life Assurance Companies Act, 1870, become or be made a member of or be insured with any other society without his written consent, or, in the case of an infant, without that of his father or other guardian; and the society to which such member or person is sought to be transferred shall within seven days from his application for admission to the

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between societies and subsequent dangerous price undercutting, incompetence, instability and fraud, amongst other things. This in turn warranted the need for major new intervention (See Macnicol, 1998:114; Broten, 2010).

same give notice thereof in writing to the society from which he is sought to be transferred.

5.4.1.1 Analysis of the regulatory changes

Although Section 30 of the 1875 Act suggests some form of market conduct regulation, the latter idea was not consciously the priority of parliamentary committees. In fact, the primary objective of the 1875 Act (and the amending Acts that would follow) was to ensure the solvency of friendly societies in the public interest. As such, market conduct regulation was not a principal consideration nor a pressing necessity since the fraternal ethos of societies and the competition for new members meant that societies were "seen to be generous in interpreting the terms of their insurance contracts with members… and their constitutions would not permit them to go against the wishes of their members" (Macnicol, 1998: 118). By defining the process to be followed by Friendly Societies in dealing with the proceeds of policies, the legislation was defining the law required for Locke's rule of law.

5.5 British Pensions Market

One of the main issues which brought market conduct to the fore is the so-called pensions mis-selling episode and attention is now turned to this matter. At this point it must be recalled that from a regulatory perspective, the focus had shifted from specific problems to regulation of financial markets. The pension fund market is simply a part of the broader financial market.

In order to comprehend the events which led to the pension mis-selling scandal and more specifically the rise of the regulation of market conduct, it is necessary to begin with an understanding of the UK's pension system. The following sections describe the pension system in the UK between the periods of 1601 to 2002 although the UK has since seen a number of subsequent pension reforms over the years (Attanasio & Rohwedder, 2003). Contemporary reforms are however beyond the scope of this study as they have no bearing on the pension mis-selling scandal. However, although the mis-selling scandal occurred in the late 1980s and early 1990s, it is necessary to track the evolution of earlier old age provision in order to provide a complete and coherent account of these developments. The following section maps the history of welfare provision starting with the seventeenth century with the passing of the poor relief at the end of Queen Elizabeth's reign in 1601.

5.5.1 Evolution of provision for the destitute, including the aged

Economic historians argue that society has evolved through four stages or states of nature. These are: the Hunter-Gatherer society, the Pastoral society, the Agrarian or Agricultural society and the Industrial society (North 1981; North 1990; Lenski, Nolan & Lenski, 1995; Vivian & Mushai, 2012). The evolution of societies influenced the provision for the aged, particularly with the fruition of modernity. The transition from the agricultural to the industrial age is of particular significance since hunter-gatherers and the pastoral society had a very short life expectancy and the weak, infirmed and aged were "simply left to die" and accordingly no specific provision was made for the aged (Vivian & Mushai, 2012). Short life expectancy continued in the agricultural age but the aged continued to live on the land they had tilled. Urbanisation, and with it the urban poor problem, was prompted by the transition from the agricultural age to the modern industrial age (Evans, 2013). Said transition ushered in higher economic growth but brought with it the wage economy, unemployment and the industrialised society which prompted the call for a more formal system of old age provision (Vivian & Mushai, 2012). In particular, as the rural poor migrated to industrial sites in search of work, urban poverty escalated (Ishay, 2008).

Historically, three systems for old age provision have emerged. These are: i) the Elizabethan Poor Laws system, ii) the Bismarckian State Pension and iii) Occupational Pensions or Personal Pension Schemes (Vivian & Mushai, 2012). These are now discussed.

5.5.1.1 Elizabethan Poor Laws System (EPL)

The earliest attempts to provide for the poor (including the aged) were the Poor Laws of 1597 and 1601 under the reign of Queen Elizabeth I following a series of bad harvests that resulted in widespread deprivation and unrest (Blake, 1995; Slack, 1995). Although the origins of parochial poor relief extend as far back as the fifteenth century, the 1601 Poor Laws are in many respects a consolidation and reiteration of earlier legislation (Higginbotham, 2011). Furthermore, the 1601 Act has come to be regarded as a milestone in British social legislation and accordingly this is the most suitable point of departure (Quigley, 1996; Higginbotham, 2011).

During the sixteenth century, Parliament passed a number of laws that set out to define the "dependent poor" and outlined the processes for providing for the destitute since poverty and

old age had become critical social problems (Lees, 1998:22). These laws were codified in 1601 and the famous yet problematic Poor Laws are often cited as marking the foundation of state welfare provision (Higginbotham, 2011). These laws however, have not been without criticism and a mere glance at the works of many leading economists including Smith (1776) and Mill (1848) bear testament to this. The institutionalisation of state provision in 1601 nominated the parish as the administrative unit responsible for poor relief, with churchwardens or parish overseers collecting poor-rates in order to finance and allocate relief (Glicken, 2011). That is, poor rates were levied on land occupiers and home owners and as such, the Elizabethan Poor Laws was and still is a non-contributory[71] state welfare system that has since been adopted by number of countries (Higginbotham, 2011; Vivian & Mushai, 2012).

The Poor Laws were problematic from inception in 1601 with the problems escalating until the reforms of 1834. During the interim, the Poor Relief Act of 1662 ('The Settlement Act'), the Poor Relief Act of 1722 and the Poor Relief Act of 1795 attempted to address some of the problems. However, calls for reform remained as the taxes to fund poor relief increased dramatically and the perceived deterioration in the quality of labour prevailed (Quigley, 1996: 117). The need for reform was eventually heeded in August 1834 when the "reform of the Poor Laws, 4 & 5 William 4, Chapter 76" was enacted. The Poor Law Amendment Act of 1834, often referred to as the New Poor Laws, is said to be the "single most important piece of legislation ever enacted" (Englander, 1998: 1). Rising costs of poor relief, rural incendiarism and industrial unrest resulted in the establishment of the Royal Commission whose primary purpose was to investigate the workings of the Poor Law and make recommendations for its improvement (Englander, 1998). By virtue of the 1834 Act, outdoor relief was abolished and an increasingly more "deterrent" poor law system was established in terms of which workhouses were deliberately maintained in unpleasant conditions (Besley, Coate & Guinnane, 2004). In particular, indoor poor relief (provided in Workhouses) would become as unfavourable as possible thereby encouraging the 'poor' to leave the workhouse in search of whatever employment was attainable in the open market (Englander, 1998).

The Poor Laws remained in operation until the National Assistance Act came into force in 1948 (Blake, 1995) as a consequence of the Beveridge Report. That is, the 1948 Act formally

[71] In terms of a non-contributory system, benefits are paid out of current contributions without the need for a contribution record (Barr, 2012).

repealed the Poor Law system and "extended and consolidated the means-tested safety net" to make further provision for the welfare of the disabled, sick, aged and other persons (Office for National Statistics, 2011; The National Archives, n.d; Department for Work & Pensions, n.d.). The essential characteristic of the Elizabethan Poor Laws system is that it is paid out of current taxes. As such, it is unfunded.

5.5.1.2 Bismarckian State Pension

Prior to the Old Age Pensions Act (1908), developments had taken place in Germany which subsequently influenced pension developments in the UK. These are now discussed. Otto von Bismarck introduced a number of social welfare systems in the 1880s in order to gain the support of the working class and to weaken the popular support for the socialist parties (Leichter, 1979). Said system is a state managed old age contributory pension scheme that is generally funded through "social security payroll tax (or payroll deductions) on a pay-as-you-go basis" (Vivian & Mushai, 2012:7). This is referred to as the Bismarckian state pension system. Contributions received, are used immediately to fund current payments to pensioners and entitlement to a pension payment is conditional upon the contribution record of those employees who had contributed to the scheme during their working lives (Natali & Rhodes, 2004). In other words, a Bismarckian scheme undertakes to provide a pension to previously employed persons who contributed to the scheme during their working lives and in this regard, the EPL and the Bismarckian systems differ (Vivian, 2010). The characteristic of this system is thus: beneficiaries make contributions via a social security payroll tax to the state administered scheme from which they draw benefits upon retirement.

In recent times, the economic sustainability of the Bismarckian pension system has come under scrutiny owing to increased longevity which has necessitated a number of reforms (Barr, 2006). The Bismarckian pension model is based on the primary goal of income maintenance (or consumption smoothing) and, since its introduction by Bismarck in Germany, it has become a common form of state provision among developed countries, including the UK (Natali & Rhodes, 2004). The UK's scheme was thus based on the German model. In fact, the UK took its first legislative steps to introduce a Bismarckian-type pension system in 1908 following the enactment of the Old Age Pensions Act which is said to be the modern foundation of social welfare in Britain (Thane, 2008). A number of authors argue that it was not until the passing of the Old Age Pensions Act in 1908 that any "systematic,

centrally organised provision for the elderly" existed (Dilnot, Disney, Johnson & Whitehouse, 1994: 10).

Arza and Johnson (2006: 56) suggest that:

> The United Kingdom's 1908 scheme… emerged from a lengthy debate in which social commentators, labour representatives, employers, and politicians sought to find a better and more systematic way of delivering assistance to genuinely needy older people [other] than by means of a stigmatising Poor Law.

Furthermore, it has been argued that rapid industrialisation and urbanisation in the nineteenth century may have been the catalyst for welfare measures of this nature (Arza & Johnson, 2006). That is, although Ashton (1964) pinpoints the start of the English Industrial Revolution to 1760, it was only in the nineteenth century that the industrial revolution was bearing fruits which manifested in an increased GDP per capital which enabled social problems (increased unemployment, rural-urban migration and the call for state old age provision, as mentioned earlier) to be addressed. Accordingly, this may have necessitated the need for the national pension scheme in 1908.

The 1908 scheme was a flat-rate, means-tested, subsistence level pension that was accessible only to the 'respectable'[72] poor over the age of 70 (Gilbert, 1970; Dilnot *et al*., 1994). In 1925, the Widow's, Orphans' and Old Age Pensions Act, a contributory pension scheme which was intended to provide only a basic pension for manual and other low-wage workers, was passed (Ogus & Wikeley, 1995 as cited in Williamson, 2002; Blake, 1995; Bozio, Crawford & Tetlow, 2010). Closely aligned to the aforementioned legislation, was the passing of the 1911 National Insurance Act following the 1909 Budget speech -'the People's Budget' (Gilbert, 1976). In 1911, the then Prime Minister, David Lloyd George introduced a compulsory health insurance scheme similar to that which was introduced in Germany in 1883 (Merrills & Fisher, 2013). Although the 1911 Act did not explicitly relate to pension provision, it did provide sickness and unemployment benefits as financed by a social security payroll tax (Blake, 1995).

[72] Benefits were available for the elderly of a 'good moral character' (Department for Work & Pensions, n.d.). Williamson and Pampel (1993) point out that the 1908 scheme maintained the Poor Law standpoint of the 'deserving poor' versus the 'undeserving or able-bodied poor' who were in fact deserving of punishment.

Following the Beveridge Report[73] of 1942, the National Insurance Act of 1946 was enacted which introduced a universal, contributory state pension from July 1948 to men of 65 years and older and to woman of 60 years and over (Department for Work & Pensions, n.d; Emmerson & Johnson, 2001). The Beveridge Report was tabled in the middle of World War II and was seen as "the dawning of a new age to replace the pre-war horrors of mass unemployment, inability to afford health care, and poverty in sickness, widowhood and old age" (Abel-Smith, 1992:5). The Beveridge Report thus signalled a change in the UK's social order and signified transformation away from the old aristocratic age. It has been argued that the 1946 Act "incorporated the old-age pensions into the National Insurance system, [thereby] unifying the social insurance program" (Arza & Johnson, 2006:66). The National Insurance Act of 1946 introduced the Basic State Pension (BSP), with effect from 1948 (Arthur, 2008). The latter will be discussed in section 5.5.2.1.

5.5.1.3 Occupational pension schemes

Occupational pension schemes are pensions schemes organised or sponsored by employers in terms of which, the company or organisation undertakes to provide retired employees with a pension (Blake, 1995; Vivian & Mushai, 2012). In the UK, since a Basic State Pension exists, occupational schemes are, in nature, top up schemes as discussed below. A large portion of employees are covered under self-administered schemes, however owing to the complexity of pension schemes for employers, a number of occupational pension schemes operate with the help of professional fund managers, pension administrators and consultants (Association of British Insurers, 2000). Blake (2003) asserts that most occupational pension schemes in the UK have been set up, in principle, as pension trust funds.[74]

Occupational pension schemes have long been a technique to encourage long-term tenure and reduce employee turnover (Budd & Campbell, 1998; Emmerson & Johnson, 2001). Historically, occupational pension schemes operated on a defined benefit basis (final salary scheme) which are funded via payroll deductions and are generally supplemented by employer contributions (Hall, 2009a). Occupational pension schemes operated on a 'defined

[73] The Social Insurance and Allied Services report.

[74] Blake (2003: 9) explains that a trust is a legal relationship between individuals and assets, by which assets provided by one individual (the settlor) are held by another group of individuals (trustees) for the benefit of a third group of individuals (the beneficiaries).

benefit basis' which exposed employers to considerable long term liabilities. To dispense with this risk, since the 1960s there has been a tendency in the private sector to move toward defined contribution occupational pension schemes.

5.5.1.3.1 Defined benefit

In terms of a defined benefit (DB) scheme, it is the pension benefit that is defined in advance conditional on the individual's years of service and some measure of earnings (Disney, 1995; Blake, 2002). That is, the employer promises to pay the assured a lifelong defined monthly pension payment upon retirement (Vivian & Mushai, 2012). DB schemes are considered favourable only to those individuals who prefer long-term employment with the same organisation since DB schemes appear to reward long-term tenure and tend to penalise mobile labourers (Broadbent, Palumbo & Woodman, 2006; Munnell, 2006). In particular, Broadbent *et al*. (2006 as cited in Josiah, Gough & Shah, 2014: 20) point out:

> A typical UK worker who changed jobs at the average level of 6 times during their working career would suffer a loss of 25-30 per cent of the full service benefit they would have received had they remained with the same employer throughout their career.

5.5.1.3.2 Defined contribution

Monies payable under a defined contribution (DC) scheme at the end of a period depend on the total contributions and investment earnings accumulated in an individual's account and accordingly, a DC scheme can be likened to a modern savings account (Bodie, Marcus & Merton, 1988). As a savings account, the defined contribution is not a pension scheme, since it does not provide a pension. Instead the accumulated savings from this individual reserve can be used to buy an annuity from an insurance company (Disney, Emmerson & Smith, 2003). In contrast to the DB scheme, it is the contribution rate that is defined in a DC plan, and the potential retirement income from a DC scheme is far more uncertain or unpredictable than the retirement income payable under a DB scheme (Blake, 2002).

5.5.1.3.3 Decline of DB schemes in the private sector

Active membership in DB pension schemes in the private sector has declined since the late 1960s whilst in contrast, DC pension plans have experienced rapid growth (Carrera, Curry &

Cleal, 2012). Aaronson and Coronado (2005) have argued that the increased cost of DB schemes was the impetus for the migration from DB to DC schemes in the UK. A number of authors indicate that the increased cost of DB plans and the difficulty in running these schemes has been influenced by a number of risk factors which ultimately affected the funding position of the scheme (as determined by the ratio of assets held in the scheme to the liabilities owed to pensioners) (Blake, 2002; Carrera *et al*., 2012; Josiah *et al*., 2014).

Carrera *et al*. (2012:23) provides an in-depth discussion of these risks and other broader social factors, as synthesised below:

i) Longevity risk: An increase in life expectancy owing to medical advancements and improved lifestyles has resulted in people living longer and accordingly, this has led to an increased post-retirement period. As a result of this, many insurance companies and employers have experienced actuarial deficits caused by an increase in their liabilities since a number of pensioners appear to have been living far beyond their pension age and not conforming to predicted mortality rates. In a DC scheme, said longevity risk is borne by the individual since it is his level of contribution (and investment returns) which ultimately affect the size of the pension pot available for future retirement income. Historically, this has been the case in the UK. As society changed, people began to live longer, families decreased in size and the proportion of old individuals to young individuals increased. It became clear that the DB schemes were building up massive deficits. This was referred to as the Pensions Black Hole.

ii) Investment risk: Investment performance is critical for sponsors of DB plans since they may be required to make a deficiency payment if the funding position of the scheme is insufficient to meet future pension promises. Equity returns appear to have been volatile over the years and as such, sponsors of DB schemes have faced great uncertainty associated with future investment returns. The migration from DB to DC schemes has meant that investment risks are now borne by the individual/employee since it is once again the combination of contributions made and investment returns that underpin the quantity of accumulated savings available for future pension provision.

iii) Regulatory and Legislative Changes: Tighter regulations regarding DB schemes and the introduction of new accounting rules meant that the attractiveness and

affordability of providing DB pension plans has declined. In fact, Vivian and Mushai (2012: 8) acknowledge that modern accounting rules require that if a deficit exists in the pension fund, said liability should appear on the firm's balance sheet. Following this, it became clear that a number of firms faced serious unfunded liabilities and firms worried that deficits disclosed would, in turn, reflect financial weakness (Josiah *et al*., 2014). As such, many companies felt it would be best for their long term sustainability to discontinue the DB pension scheme in favour of a DC scheme since the investment risk would fall on the assured (The Occupational Pensioner's Alliance, n.d.). In addition to this, the 1986 legislation allowed firms and workers to contract out of employer-sponsored DB schemes into individual personal pensions offered by insurance companies or self-administered employer schemes on a DC basis. A number of employees did so since the accrual losses associated with DB plans could be mitigated by way of a DC pension plan (Broadbent *et al*., 2006).

iv) Labour market mobility: The UK has witnessed significant labour market changes resulting in increased labour market mobility. Since DC schemes have the advantage of portability, the latter has dominated the private sector since the post-war period.

Furthermore, DB schemes were thus becoming increasingly unsustainable in the private sector. Changing the benefit structure in pension provision was therefore the private sector's response to the increasing costs of pension provision on a DB basis. Furthermore, Broadbent *et al*. (2006) emphasises that the shift from DB to DC schemes reflects the regulatory and accounting reform which has made the financial risks associated with DB plans more transparent. "Since DC contributions can be fixed as a predictable share of payroll, migrating to a DC plan offers employers a means of reducing balance sheet and earnings volatility, at least over the long term" (Broadbent *et al*., 2006: 2).

5.5.1.4 Personal pension provision

In a personal pension scheme, an individual accumulates his or her pension contributions in a fund (via monthly contributions), the proceeds of which are then used to provide a pension upon retirement either through endowment or an annuity (Disney & Whitehouse, 2005). In contrast to an occupational pension scheme, an employer is not required to contribute to a personal pension, and usually does not do so (Black & Nobles, 1998b). Personal pensions play a significant role in providing a retirement income for the self-employed or for those

employees who do not have access to an occupational pension scheme (Association of British Insurers, 2000). According to Black and Nobles (1998b:795), the amount paid upon retirement is dependent on a number of factors including: i) the contributions paid by an individual (to ensure an adequate pension), ii) the investment performance and/or return of the fund into which the contributions have been paid, and iii) the fund manager's charges.

5.5.2 Conservative Government

Since its inception in 1948, there had been discontent with the state scheme, especially the flat rate benefit. This resulted in a number of attempts to improve the system. The Conservative government's pension reforms culminated in 1986 and resulted in a four-tier pension system characterised by a mixture of unfunded state provision and funded private provision (Schulz, 2000; Blake, 2003). The four major retirement income vehicles, at the time, included the Basic State Pension (BSP), the State Earnings Related Pension Scheme (SERPS), the employer sponsored occupational scheme and individual Personal Pensions (Blake, 2000). The history of each pension system is discussed below.

5.5.2.1 Basic State Pension

The National Insurance Act of 1946 introduced the BSP which formally came into effect in 1948 (Bozio *et al*., 2010). Although the Beveridge Report had envisaged a fully funded universal scheme, the government opted rather for a "pay-as-you go" system financed by flat-rate contributions on employees whose earnings fell above the lower earnings limit threshold (Disney & Whitehouse, 1993; Whitehouse, 1998; Attanasio & Rohwedder, 2003). The problem was that the pension would become payable to the then current retiring workers who had not contributed to the scheme because it had not yet come into existence. Parliament would not agree to any contribution from general taxes. The scheme had to be funded out of social security payroll contributions. Individuals paid National Insurance (NI) contributions based on overall budgetary needs and the "distributional objectives" of the government (Bozio *et al*., 2010: 8). The latter meant that the flat-rate contributions required to finance current pension funding was particularly onerous on low-paid workers. Clearly these workers paid a greater percentage of their income in comparison to high income earners. The flat rate contribution system had to be abandoned in favour of a form of earnings-related contribution payments (Whitehouse, 1998).

The full BSP was payable on a weekly basis to individuals who were above the State Pension Age (SPA)[75] and who had made a sufficient number of contributions over their working life (Blundell, Meghir & Smith, 2002). An individual who had contributed at least nine-tenths (90%) of his or her working life was entitled to a full benefit pension (Attanasio & Rohwedder, 2003). In other words, if an individual was credited with the "requisite number of qualifying years out of their working life, they [would] receive a BSP at the full rate. If they [had] fewer qualifying years than this, a pension [would be] payable at a pro-rata rate" (Bozio *et al*., 2010:12). As such, the BSP was not quite universal, as the contribution requirements mentioned above ought to have been satisfied in order for an individual to be able to have claimed a full pension (Dilnot *et al*., 1994; Johnson & Stears, 1996).

Furthermore, additional means-tested welfare benefits were available for those deemed to have inadequate benefits- often referred to as "the most needy" (Budd & Campbell, 1998). In other words, low income earners who qualified for additional welfare benefits, were entitled to added social security payment subsidies on top of the BSP (Blundell, Fry & Walker, 1988). During the mid-1900s, roughly 15% of pensioners were dependent on the minimum means-tested benefit income support on top of the state pension (Blundell & Johnson, 1999).

By the late 1950s, about two-thirds of employees were dependent on the state pension (Bozio *et al*., 2010). However, since the BSP provided the bare minimum in pension provision and left many workers on or below subsistence-level income, there was increased pressure to introduce an earnings-related top-up to the BSP for those employees who did not have access to an occupational pension (Whitehouse, 1998; Taylor-Gooby, 2005). In addition to this, Abel-Smith and Townsend (1965) argue that the penalties incurred by early leavers in occupational pension schemes and the unwillingness of government to make occupational pension schemes mandatory for all employees, may have further exacerbated the need for a state second-tier pension.

[75] Between 1948 and April 2010 the official SPA was 65 for men and 60 for woman. However, between April 2010 and March 2020 the SPA will increase by one month every month until the SPA for woman equates to that of men (65 years). This will ensure financial sustainability of the scheme on the basis of increased life expectancy (see Bozio *et al*., 2010).

5.5.2.2 State Earnings Related Pension Scheme (SERPS)

The National Insurance Act of 1959 introduced the Graduated Retirement Benefit (GRB) which offered a modest state earnings related pension (Dilnot *et al*., 1994). The scheme was relatively short-lived as benefits payable were too meagre and as such, the graduated pension was superseded by SERPS in 1978 (Blundell & Johnson, 1999). As a result of this, the Social Security Act of 1975 introduced SERPS to supplement the "minimal and inadequate" BSP and as such, SERPS formed the second tier in state pension provision (Whitehouse, 1998; Budd & Campbell, 1998; Schulz, 2000:94).

SERPS aimed to pay 25 per cent of average individual earnings in the best 20 years' earnings[76] and were payable together with the BSP (Whitehouse, 1998: Attanasio & Rohwedder, 2003). In order to avoid industry opposition, the government designed the contracting out scheme to ensure that the private sector (and particularly employer-provided pension funds) would not be suppressed by the introduction of SERPS and accordingly, that good opportunities for the private sector would remain (Whitehouse, 1998; Attanasio & Rohwedder, 2003; Taylor-Gooby, 2005). As a result of this, employees who belonged to an occupational pension scheme could opt out of SERPS (and pay a reduced NI contribution rate) as long as the occupational pension scheme guaranteed at least the same pension benefit as that of SERPS- 'a guaranteed minimum pension' (GMP)[77] (Blundell *et al*., 2002). Such schemes were known as contracted-out salary-related (COSR) schemes (Bozio *et al*., 2010). Employers usually made membership of their occupational scheme a condition of employment and accordingly, pension arrangements at the time were characterised by very little freedom of choice (Sullivan, 2004).

5.5.2.3 Occupational pension schemes

Although occupational schemes had long existed before the Second World War, they became particularly widespread in the tight labour market post war (Bozio *et al*., 2010). In the 1960s, occupational pension schemes were largely the domains of "full time, unionized, male workers" in large companies and in the public sector (Emmerson & Johnson, 2001: 24). In

[76] Subsequent reductions in the generosity of SERPS meant that it was worth only 20% of average lifetime earnings to anyone retiring after 2000 (Blundell *et al*., 2002).

[77] This requirement was subsequently abolished and occupational schemes merely had to demonstrate that they satisfied the reference scheme test (see Blake, 2003).

addition to this, employers could provide private pensions to attract key workers (without being forced to include lower income earners) and as such, employer based occupational pension schemes were particularly dominant amongst high income white-collar workers (Emmerson & Johnson, 2001; Sullivan, 2004; Munnell, 2006).

Up until the 1986 legislation, approved occupational schemes had to be of the defined benefit form (salary-related pension schemes) (Budd & Campbell, 1998:112). In fact, Disney (1995:21) points out that since only DB plans could attract approved status under the original provisions of the contracting-out legislation, it is not surprising that DB provision was the dominant form of occupational pension plan provision in Britain. In spite of this, there has been a growing trend for employers to close the existing DB schemes to employees and opt rather for a DC scheme in order to have greater certainty with regard to costs[78] (Association of British Insurers, 2000: 16). As mentioned above, this was owing to the massive deficits that DB schemes were building up which was referred to as the pension Black Hole. Notwithstanding the legislative changes in 1988, which prevented employers from making membership to their scheme a condition of employment, occupational pension schemes appear to have remained relatively widespread (Emmerson & Johnson, 2001).

5.5.2.4 Personal pensions

The defining feature of Thatcher's Conservative Government (1979-1990) was its attempts to control public spending through privatisation (Hills, 1998). The government was keen to reduce their liabilities in terms of SERPS. These measures included making systematic "cuts" in state pension provision and transferring the burden of pension provision to the private sector through a number of tax incentives and deregulation of the private sector (Blake, 2003). This is consistent with Thatcher's ideal to "roll back the state" and restrict public spending (Taylor-Gooby, 2005). In fact, "Britain is the only G-7 nation that has made the transition from a largely public PAYG earnings related scheme to a partially privatized alternative with funded individual accounts" (Williamson, 2002: 416). The rational for said reforms was the so-called population aging which was said to have resulted in an unfavorable and unsustainable cost of future pension provision (Taylor-Gooby, 2005).

[78] About 15% of employees are now thought to be covered by DC schemes (Association of British Insurers, 2000).

With the pervasive ideology of privatisation and a further re-examination of public spending, the 1986 Social Security Act consisted of a number of measures to encourage individuals to leave SERPS (Whitehouse, 1998; Rees & Kessner, 1999; Blake, 2003). It was at this time that government was concerned with the projected cost of SERPS once the "baby boom" generation began to retire and accordingly, sought to further reduce public expenditure (Hemming & Kay, 1982; Department of Health and Social Security, 1984 as cited in Disney, Emmerson & Smith, 2003). In particular, it was expected that dependency ratios (the ratio of retired individuals or households to those of a working age) would escalate in the future (Banks & Emmerson, 2000: 4).

In 1988, the Conservative government gave tax and "national insurance concessions" with the desire to encourage individuals to opt for portable personal pensions as opposed to state provision under SERPS or occupational pension provision (Hills, 1998). Government thus designed and promoted a new pension dispensation – the age of the personal pension scheme was born. An employee could choose to opt out of SERPS even if the employer did not offer an occupational pension scheme provided that the employee joined a so-called "Approved Personal Pension" or a contracted out money-purchase (COMP) scheme. (Attanasio & Rohwedder, 2003: 1503; Bozio *et al*., 2010). This was done not only to further reduce public spending but also to give employees a greater freedom of choice since employees themselves could decide whether to contribute to SERPS, their employers' pension schemes or a personal pension scheme (Sullivan, 2004).

The Conservative government endeavoured to ensure that personal pensions would succeed by reducing the generosity of public pension benefits, introducing rebates, tax relief, and incentive bonuses and embarking on an aggressive advertising campaign that set out to convert employees to the new personal pension option (Schulz, 2000: 95: Banks & Emmerson, 2000). The important point to realise is whatever scheme replaced SERPS would have to be, right from its inception, far inferior to these existing schemes. The pensioners would, by design, be worse off. However, this is not what government marketing had projected. Government advertising unreservedly celebrated the new personal pension plan era.

Following the 1988 pension reform, around 6 million people (more than one-quarter of all employees) had taken out a personal pension by the mid-1990s (Blundell *et al*., 2002). This

was not only owing to major financial incentives, but also the lure of the stock market boom and supposed stock market gains which meant that individuals saw private pension saving as the better alternative to state run schemes (Vincent, 2003). This was despite the capital market uncertainty and high transaction costs of private pension provision (Whitehouse, 1998). It later transpired that a number of individuals who had taken out personal pension plans did so to their detriment resulting in the pension mis-selling scandal (Rees & Kessner, 1999).

5.5.3 Pension mis-selling scandal

As mentioned earlier, a potential source of market conduct regulation are events such as the pensions mis-selling scandal, which is now considered.

Following the 1988 legislation, government and insurance companies embarked on a vigorous campaign to promote their "personal pension" products since individuals were able to opt out of both SERPS and/or their occupational pensions into an approved personal pension scheme (Bennett & Gabriel, 2001). Personal pensions were available from a number of providers including insurance companies, building societies, unit trusts, banks and other financial organisations (Budd & Campbell, 1998; Black & Nobles, 1998b; Association of British Insurers, 2000). The vast array of pension providers resulted in a highly competitive private pension market and many authors argue that this may have contributed to the mis-selling of personal pensions in the 1980s (Soin & Huber, 2013).

Government ministers and politicians also openly endorsed the personal pension system and as many as 550 000 personal pensions were sold during the next four months (Aldridge, 1997; Bennett & Gabriel, 2001). There are no records to suggest that when the proposal was made to transfer out of occupational schemes to the personal pension plans that anyone (including an actuary, regulator, politician, insurance company, pension fund administrator or the financial press) warned that new scheme would be to the disadvantage of existing members opting to transfer. Nonetheless, it later transpired that a number of individuals purchased personal pensions to their detriment resulting in the so-called pension mis-selling scandal (Rees & Kessner, 1999). Schulz (2000: 93) points out:

> … the political rhetoric at the time sounded good: bigger pension benefits, lower government pension costs, greater individual control, investment

> flexibility and [the] use of supposedly more "efficient" private companies. But the reality has turned out to be much less than was promised.

It is important to emphasise however, that at no time was it a condition of the personal pension scheme that the returns had to be equal or superior to the existing state defined benefit schemes. This was never built into the scheme. The private financial market was not required to guarantee equal performance. The private financial sector could create, operate and manage the new private pensions but they could not make them more beneficial than the defined benefit scheme. The private financial market never said it could. In fact, the new system, as mentioned above, would naturally be inferior. This was inevitable but instead of the government pointing out this inevitability, the private financial market became the 'fall guy'. The private sector was accused of mis-selling the private pension plans.

It has been cited that the "scandal" revealed itself in 1992 following a report by the Pension Law Review Committee and a review of SRO members' pension sale files by the SIB (Black & Nobles, 1998a; Bennett & Gabriel, 2001). It was found that a mere nine per cent of insurance firms displayed adequate record keeping and compliance with the "know your customer" and "best advice" rules. This prompted further investigation.

Since the typical retiree lacks both the expertise and the technical knowledge to deal with complex pension issues, the industry itself is often called upon to provide the necessary advice (Ring, 2005). The mis-selling scandal was the adverse product of such since most individuals were "ripe for the picking - looking for quick and easy answers and finding it difficult to easily evaluate, in an informed way, the advice they receive[d]" (Schulz, 2001: 98). Black and Nobles (1998a: 793) assert that 'mis-selling' could refer to any one range of situations, namely: i) the use of deliberate strategies to sell products to individuals which were known to be unsuitable; ii) the use of aggressive and often unethical sales strategies; iii) the failure to give suitable advice when it is needed and; iv) the ignorant and incompetent selling of inappropriate products.

There are four main examples or scenarios where the so-called 'pension mis-selling' occurred (Whitehouse, 1998:24). Each of these instances is discussed below:

i) Certain elderly individuals who were persuaded to 'contract out' of SERPS in favour of a personal pension scheme, fell victim to the mis-selling scandal since SERPS offered a better pension alternative to the vigorously marketed personal

pension. Early contributions made merely covered the high transaction costs incurred and the short time frame in which returns may have been realised meant that contributions would have insufficient time to generate an adequate fund (Taylor-Gooby, 1999). The latter is depicted in Figure 1 below (as described in Whitehouse, 1998:15).

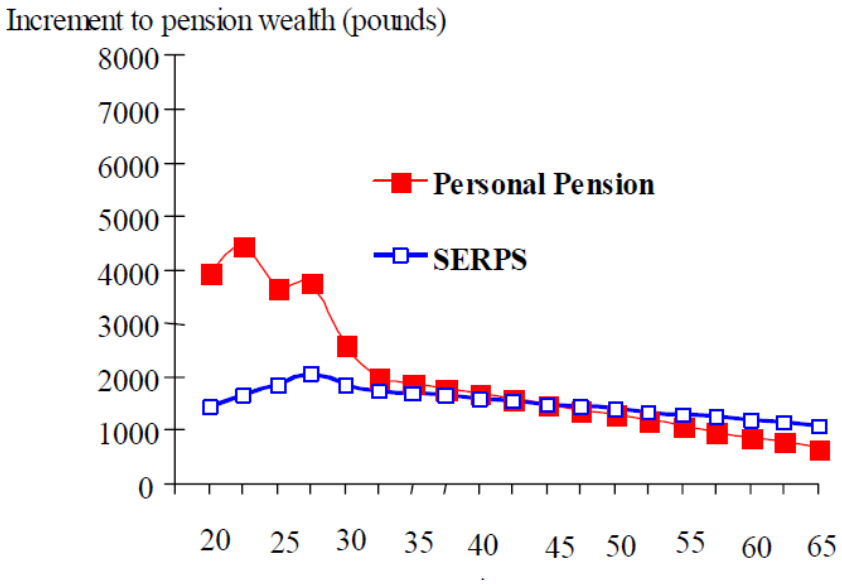

Figure 1: Marginal Increment to Personal Pensions and SERPS at various ages (prior to 1993)

ii) Individuals who fell below the lower earnings threshold, and particularly woman, were said to have been mis-sold personal pensions. This was owing to the fact that DC personal pension schemes depend on the quantum of contributions made. Since the contributions paid were often inadequate to bear the high transaction costs, accumulated benefits were insufficient at retirement (Whitehouse, 1998; Ward, 2000).

iii) A number of individuals, who were persuaded to transfer their pension out of an occupational plan into a personal pension scheme, were also casualties of the mis-selling scandal. The latter appears to have been the most significant case of pension mis-selling and accordingly, has attracted wide review.

Until 1988, membership to an employer's pension scheme could be a condition of employment and accordingly, by this time, a number of individuals working for a larger employer were likely to have accrued workplace pension benefits (Pensions Management

Institute, 2013: 1). The 'hard selling' of providers who focused on the national rebate incentive and down played the transactions costs associated with personal pension schemes, saw millions of individual move from good quality occupational schemes to the inferior alternative (Disney & Whitehouse, 1992; Pensions Management Institute, 2013:1). Mis-selling was said to have occurred since a number of individuals were left substantially worse off thereafter.

The latter may be attributed to a number of factors. To begin with, individuals were worse off after transferring their assets to an approved personal pension scheme, since an employer was no longer obligated to contribute to the private pension plan (Black & Nobles, 1998b). That is, employers would usually make contributions to an occupational pension plan (worth 70 per cent of the pension on average) but would rarely make such a contribution to a personal pension scheme (Blake, 2002). As such, the lack of employer contributions meant that there was little chance that a personal pension would yield a better investment than its occupational pension counterpart. To emphasise this point, Blake (2002:334) reports that a miner who transferred to a personal pension scheme in 1989 and who retired in 1994 at age 60 would receive a lump sum of £2576 and a monthly pension of £734. On the contrary, had he remained in his occupational pension scheme, that same miner would be entitled to a lump sum of £5125 and a monthly pension of £1791.

In addition to this, scheme members were further disadvantaged because 25 per cent of the transfer value was taken in commission and other administration costs (Blake, 2002). In summary, the UK's Office of Fair Trading (1997: 8 as cited in Barr & Diamond, 2008) pointed out that:

> Many personal pensions are… simply poor value. Their benefits are consumed in the high levels of expenses needed to support the marketing effort and active management of the funds. In comparison with most occupational schemes, the level of employers' contributions may be inadequate or non-existent.

Moreover, occupational pension schemes generally offer "death in service benefits" (a form of life assurance risk benefits) [79], "ill health benefits" (a form of disability insurance) and

[79] The provision of risk benefits by a pension fund is common practice but has complications. The pension fund is not a registered licenced insurer and thus legally the risk benefits should be provided by an insurer. This then

other benefits to spouses and dependants (Black & Nobles, 1998a: 940). On the contrary, personal pensions would typically only offer these benefits as optional extras. Accordingly, scheme members who opted to join personal pension schemes not only sacrificed their employer's contributions but also forfeited these aforementioned benefits.

v) Lastly, individuals who were persuaded not to join an employer sponsored pension scheme in favour of a personal pension scheme are included in the estimate of those affected by the scandal. The reasons for this are similar to those listed above in point iii.

Once again, it is important to remember that the pensions Black Hole meant that the state system had to change and in terms of the new system pensioners naturally would be much worse off. This would be the outcome with whatever new system replaced the old system despite claims of 'hard-selling' and the various regulatory weaknesses, discussed below. There was nothing wrong with the replacement schemes but in reality, said schemes could not produce the same outcomes which had become unsustainable.

5.5.3.1 Regulatory failures

Upon examination by the accountancy firm, KPMG, a random sample of 735 transfers from occupational pension schemes between 1991 and 1993, revealed that over 90 per cent of these cases exhibited some mis-selling (Sullivan, 2004:93). This appears to be so since "virtually every case examined" exhibited unsatisfactory regulatory compliance, inappropriate advice and inadequate and incomplete case files (Schulz, 2000). Regulators relied on these factors in order to shift the burden for compensation onto the unsuspecting financial market.

As a result of these factors, the focus of attention at this time was directed toward what had been done by both firms and regulators to prevent the mis-selling of personal pensions (Black & Nobles, 1998a). The answer to this question represented a large scale failure by the regulatory system (Minns, 2001). Government had found regulating the private sector difficult since it was the very sector that it sought to promote (Taylor- Gooby, 2005). As such, the private pensions market remained within a weak regulatory regime (Taylor-Gooby, 2005). Furthermore, the SRO system was "thoroughly discredited in the eyes of opposition

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raises the question as to the role of the pension fund. Is it an agent of the insured or is the insured the fund which is insuring itself against the risk? These questions are usually neither asked nor answered.

lawmakers" (Taylor, 2009:67). This was compounded by the Robert Maxwell scandal (Taylor-Gooby, 2005). [80] Accordingly, the apparent failure of the SRO structure was the catalyst for further regulatory reform and could possibly be attributed to the i) complicated relationship between SROs and the statutory regulatory, ii) the inability of self-regulation to raise the standards in the market as a whole and iii) the failure to deal with a problem where there was a need for the entire industry to change (Davies, 2001:281).

Moreover, and as mentioned above, Black and Nobles (1998a) note that following the mis-selling scandal and upon investigation, a number of firms admitted non-compliance. That is, "there had been a widespread breach of the "best advice" and "know your customer" rules which represented a major regulatory failure by both regulators and firms" (Black & Nobles, 1998a: 941). According to a Parliamentary Committee Report in 1998 (as cited in Minns, 2001) "the Treasury said that the Regulatory system failed to prevent, or deal more swiftly, with mis-selling because firms simply did not abide by the regulatory rules". Furthermore, following a review of Black and Nobles (1998a) and Black and Nobles (1998b), a number of other factors can be attributed to the so-called regulatory failures that resulted in the mis-selling scandal. These factors are listed below:

- *Inadequate Management Supervision:* On the backdrop of increased competition within the UK's insurance market, insurance firms sought to expand their direct sales forces to ensure that as many brokers as possible would sell the company's products. This was done to the detriment of both the management supervision and training of such financial advisors. In fact, advisors were frequently recruited without sufficient checks since insurance firms were looking for people "capable of producing a reasonable level of business, and quality came second". In addition to this, SRO's had a difficult time ensuring compliance since they had no direct contractual relationship with an appointed representative (AR) and therefore were unable to act directly against them. Coupled with the fact that insurance firms often lacked an

[80] The SROs were heavily criticised for failing to protect the interests of consumers in a number of high-profile financial scandals including the Maxwell affair. By 1991, over £440 million from pension funds had been fraudulently misappropriated by Robert Maxwell to buttress a number of business failures. Said scandal is often referred to as the Mirror Group Pension scandal. See Stiles & Taylor (1993); Spalek (1999) and Ferran (2003) for further discussions.

understanding and awareness of what was involved in the management of a sales force, the casualty in this instance was inadequate supervision and control of AR's.

- *Inadequate training of salesmen:* The low levels of training and competence of salesmen further exacerbated the regulatory failures of insurance firms. In 1988, LAUTRO published a number of rules, one of which required that a company appoint representatives who had the "requisite aptitude and competence". However, it was later revealed that a mere thirteen days of training was all that was necessary before an agent could meet with a client. During the period of 1989-1991, 54 percent of new sales recruits left the market. Owing to the high level of turnovers, training was costly for firms whom ultimately resorted to ignoring the abovementioned requirements. The lack of training regarding occupational schemes further compounded the mis-selling scandal. In fact, Lord Hoffmann in *General Insurance Holdings v Lloyd's Bank Group Insurance Co. Ltd* UKHL 2003 48 asserted that "the underlying reasons for mis-selling [was] partly the method by which salesman were paid but largely the inadequacy of the training and monitoring of their performance provided by the companies employing them". Since salesmen had neither the understanding nor the knowledge of the nature of occupational pension schemes, or their benefit structures, they were unable to make the necessary detailed comparisons and therefore did not always provide "best advice". In fact, in February 1992, LAUTRO issued its fourteenth bulletin and commented that:

> Company representatives too often fail to make a sufficiently detailed, realistic or objective analysis of the relative merits of transferring their prospective investors to a personal pension or leaving them in their occupational scheme. Sometimes it is because the representatives have not been trained regarding how and why they should undertake such an analysis. Sometimes they have been adequately trained but nonetheless choose to ignore the requirement.

  As such, and as mentioned above, a number of ineligible individuals were 'mis-sold' pensions.

- Commission structures: The low levels of training and competence was further reinforced by the fact that advisors had no incentive to partake in training since their remuneration structure was sales driven on a commission only basis. That is, "time spent in training was time not spent selling, and no sales meant no income". As a

result of the pressures to receive an income, advisors often negated the exhortations for ‘quality business’ and thereby paid little attention to sales ethics and the “niceties of know your customer”. Compliance with these rules would often result in no sale. Furthermore, commission structures meant that salespersons had every incentive to downplay the disadvantages or problems with the product and in doing so failed to safeguard the best interests of their client. Although persistency rates and “commission claw back arrangements” were ways of incentivising the sale of quality business, the combination of “claw backs(s), volume-related performance indicators and commission-only remuneration” resulted in commission hungry advisors.

- Ineffective Compliance Officers: During the reign of the FSA regulatory system, firms were required to ensure their own compliance by employing an assigned compliance officer. This new role brought with it a number of uncertainties since compliance officers were entering into unchartered territory in terms of which there was no benchmark as to how to operate. As a result of this, compliance systems appear to have been inadequate, unsatisfactory, disorganised and severely under-resourced. Furthermore, periodic monitoring appears to have been weak and serious compliance shortcomings necessitating further remedial action were evident.

- Novelty of the regulatory system: Regulators had little experience as to what standards should be imposed and lacked a detailed understanding of the necessary regulatory framework. Furthermore, regulatory officials often lacked the necessary ‘industry background’ and accordingly, lacked specific product knowledge. As a result of this, the initial ‘advisory visits’ were more of a way to educate themselves about the industry than it was to introduce the industry to regulation.

Over time, it became clear that regulators had not pre-empted the scandal since they were “simply not looking” (Black & Nobles, 1998b). That is, sales techniques, marketing procedures, and compliance with “suitability of cover” and “best advice” were simply not the priority of regulators. However, it can be argued that the source of the pensioners’ loss was not bad advice or the various other regulatory failures that are often cited; it was the move to a deliberately designed inferior system as a result of necessity in order to reduce and ultimately get rid of the pension Black Hole.

These regulatory failures, *inter alia*, nonetheless signalled the need for far greater regulatory oversight. In fact, the pension mis-selling scandal has been cited as one of the principal reasons for regulatory reform undertaken by the Labour Government since consumer protection measures in legislation were deemed to be inadequate[81] (McMeel, 2013: 598). This culminated in the i) establishment of an independent new body known as the Occupational Pensions Regulatory Authority (OPRA), ii) the formation of a new body, the FSA (as discussed above) and iii) the passing of the Financial Services and Markets Act of 2000 which repealed the 1986 Act (discussed earlier) (Lowry & Rawlings, 2004; Barr & Diamond, 2008). It was during this time that the Labour Government recognised and decided there were too many regulators, and therefore announced that the eight existing financial services regulators would be merged into a single authority, under the control of the old SIB[82] (thereafter renamed the Financial Services Authority in 1997)[83] (Ford, 2011: 268).

The FSA officially opened its doors on 1 June 1998 and assumed responsibility for insurance regulation in 1999. It was also at this time that the International Association of Insurance Supervisors (IAIS) was established to which UK insurance supervisors soon became members[84] (Ford, 2011).

5.5.3.1.1 Assessment of the nature of the regulatory changes

It can be accepted that mis-selling falls squarely within the purview of market conduct and hence the pensions mis-selling played a significant role in the rise of the second peak- the market conduct peak. The current regulators' obsession with advice, intermediaries, the RDR and the like can be traced back largely to this saga.

The pension mis-selling saga is complex. From the 1960s onwards it was becoming clear, for the reasons set out above, that defined benefit schemes were likely to run into a loss in the

[81] In fact, as early as 1995, the Labour Party (then in opposition to the Conservative party) clearly expressed that it would "remove the last remnants of self-regulation and the "unnecessary" distinction between the SIB and the SROs" if it were to come into power (Ferran, 2003).
[82] The failure of the SRO's was to be expected, within the insurance context. As mentioned before, the system was a failure from the day it was put into practice. The tariff committees, which possessed a number of similar characteristics to Gower's system, had been closed down shortly before the SRO self-regulatory system following the report of the Monopolies Commission. It is odd to see one government institution shutting down self-regulatory bodies whilst another was creating them.
[83] It is often confused that the FSA was established in 2001 following the passing of the FSMA 2000 which came into effect in 2001. Accordingly, the establishment of the FSA preceded the passing of the FSMA 2000.
[84] The FSA only became fully in force from the 30 November 2001 although it had existed from 1997 following the renaming of the SIB, as noted above.

future. These future losses could be translated through accounting rules into current pension fund deficits. It was therefore in the interests of the government as the provider of state pensions, as well as the private sector as providers, to create and promote private pension schemes which would hide this problem. Since the pension deficits were unsustainable, the change was inevitable. Pension funds would be relieved of their problems which would materialise as lower returns for pensioners. As a rule, pensioners would not know they were worse off since what they knew was what they had and not what they would have had in a different system. In the case of the UK, since both systems co-existed, those who changed to the new system could be compared to those who did not change. At this point, it became a blame game. It was in the interests of government, employers (public and private) and regulators to blame the private sector financial industry. In that way they could also shift their pension fund costs onto the financial market. The blame was personified as "bad advice" which was said to be the impetus for regulatory reform. Since some companies admitted non-compliance to various other requirements, shifting the blame onto the private sector became that much more reasonable and easier, although many of these issues had little to do with the inevitable outcome of pensioners being worse off.

5.6 Supervisory Agencies

5.6.1 International Association of Insurance Supervisors (IAIS)

As mentioned above, UK regulators joined the International Association of Insurance Supervisors (IAIS) described by some as the "closest approximation of an international insurance regulatory body" (Kochenburger & Salve, 2011). Established in 1994, the IAIS is a "voluntary membership organization of insurance supervisors and regulators" that is responsible for drawing up standards and developing and assisting in the implementation of principles and standards in the insurance sector worldwide (IAIS, 2014). The globalisation of the insurance business has created the need for a regulatory body which operates through an international perspective (Kochenburger & Salve, 2011). According to its mission statement, the IAIS undertakes to "promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability" (NAIC, 2014a). The IAIS has no regulatory power, binding ability or legal authority, however it can be credited with influencing national and regional regulators through various

means (NAIC, 2014a). These include the publication of supervisory principles, the provision of training and support and its endeavour to advance the latest developments in international regulation (NAIC, 2014a).

In December 1999, the IAIS published a set of "Principles for the Conduct of Insurance Business". In particular, said principles were expected to improve insurer, intermediary and consumer relationships and thereby strengthen consumer confidence and protection. According to the IAIS principles, insurers and intermediaries should:

- Act at all times honestly and in a straightforward manner;
- Act with due skill, care and diligence when conducting their business activities;
- Conduct their business and organise their affairs with prudence;
- Pay due regard to the information needs of their customers and treat them fairly;
- Seek from their customers information which might reasonably be expected before giving advice or concluding a contract;
- Avoid conflicts of interest;
- Deal with their regulators in an open and cooperative way;
- Support a system of complaints handling where applicable; and
- Organise and control their affairs effectively.

By this time, the Association of British Insurers (ABI) had already come into existence with a number of insurance companies becoming members thereafter[85]. According to the Association of British Insurers (2014), their role, amongst other things, is to publish research reports and policy documents, support a competitive insurance industry and promote best practice, transparency and the highest standards of customer service. The ABI has

[85] Up to date, 300 companies, accounting for 90% of the UK's insurance market are members of the ABI (see ABI, 2014).

endeavoured to achieve the latter by publishing a sequence of best practice guidelines. Member companies are required to comply with these codes of conduct.

According to the ABI's 'General Insurance Business Code of Practice for all Intermediaries', an intermediary shall:

- As an overriding obligation, conduct business at all times with utmost good faith and integrity;
- Explain all the essential provisions of the cover afforded by the policy (including any restrictions and exclusions which apply) so as to ensure that the potential policyholder understands the cover being purchased
- Avoid influencing the prospective insured; and
- Ensure as far as possible that the policy proposed is suitable to the needs of the prospective policyholder.

5.6.2 Occupational Pensions Regulatory Authority (OPRA)

Government introduced tighter regulation by virtue of the 1995 Pensions Act which established a new authority, the Occupational Pensions Regulatory Authority (OPRA), and which superseded the Occupational Pensions Board (OPB) in 1997 (Sullivan, 2004; Taylor-Gooby, 2005). [86] The latter however applied only to the occupational pensions sector and accordingly, OPRA was responsible for the supervision of occupational DB pension schemes only. OPRA had the authority to remove, suspend and impose fines on employees or trustees, wind up and terminate schemes, impose injunctions and interdicts and establish minimum funding requirements. Since OPRA did not appear to have had any role in regulating the market conduct of occupational pension schemes, it would be superfluous to continue with any further and more comprehensive discussion.[87]

[86] The life of OPRA was however short-lived.

[87] In April 2005, OPRA was replaced by a new "Pensions Regulator" (See Department for Work and Pensions, 2005; Parliamentary and Health Service Ombudsman, 2006).

5.6.3 Applicability of economic theories of regulation

The basis of the economic theory of regulation is that individuals (or classes of individuals) can and will use legislation to their own advantage. In line with Stigler's (1971) theory of regulatory capture, industries can capture regulators in order to use regulation to the industry's advantage. In the theory of Public Choice, it is argued that politicians promise legislation which would benefit their constituencies. In return, politicians are elected. Politicians personally gain in return for these benefits. The exchange is votes for benefits.

The rise of "independent" supervisory agencies can be explained on the same basis of self-interest. Legislation does not originate from parliament. Regulation is sent to parliament for approval from government departments and agencies. In terms of the theory of self-interest, the possibility exists that this legislation benefits the agencies which include the employees within these agencies. That is the case and becomes self-evident when recent supervisory legislation is examined. These agencies, in particular, tend to be self-funding. That is, the agency imposes a levy on the regulated industries. This is taxation without the consent of the payer of the levy. However, unlike taxes, parliament does not approve the levies. Furthermore, the agencies are increasingly issuing their own "laws". Likewise, these laws do not go through parliament.

5.7 Conclusion

Over the course of the past three centuries, the insurance market in the UK has witnessed extensive regulatory developments and reform. Regulators or supervisors are new institutions having been established after 1986, the date of the passing of the Financial Services Act. Since this date, the supervisory structure has grown, now extending to international committees. This has replaced the system of self-regulation which traditionally governed financial institutions.

In the 17th century, following the establishment of the Office (Chamber) of Assurances in the Royal Exchange, certain good insurance orders developed so as to put London on the map as a highly regarded and emerging insurance market. Thereafter, both the Lloyd's market and friendly societies came into existence, each with their own regulatory systems often described as self-regulatory in nature.

This section has identified and discussed the three most fundamental and recent developments that have changed the shape of insurance regulation in the UK with particular attention to the progress of market conduct regulation. As mentioned above, the most notable market conduct events include: i) the development of the European Economic Community (EEC) regulation in 1957 and the UK's accession thereto (to be discussed in the succeeding section) ii) the introduction of the Financial Services Act of 1986 amid various investment firm collapses and iii) the passing of the Financial Services and Market Act of 2000 which established a far more sophisticated approach to regulation.

Upon reflection of the history of regulation in the UK, one can argue that the British system of market conduct regulation started in 1986 and developed further in the early 2000s with the passing of the FSMA giving credence to the defunct 1986 Act. Market conduct regulation in the UK is structured on the basis of: i) Primary legislation (including the Consumer Contracts Regulations of 1999 and FSMA 2000), ii) regulatory rules and guidance contained in various handbooks, iii) regulatory interpretations of rules that are issued by the regulators themselves and iv) the outcomes of decisions made by the Financial Ombudsman Service (FOS).

One can deduce that the early regulatory developments that have taken place in the UK were largely reactive in nature (in response to a number of scandals and collapses). In particular, a large majority of the more recent regulatory developments, as discussed above, were in response to a number of investment scandals and collapses and not insurance ones. Notwithstanding this, the pension mis-selling scandal in the early 1990s has had a considerable impact on the insurance regulatory framework, especially on the distribution of insurance products which hence is impacting on intermediaries.

The pension mis-selling scandal is said to have been the result of a complex interaction of a multitude of factors, some of which included inadequate management supervision, inadequate training of salesmen, commission structures and ineffective compliance officers. This represented a major regulatory failure by both regulators and firms. This eventually saw the establishment of the FSA, replacing the earlier Securities and Investment Board (SIB) and the founding of a set of principles of good practice and a collection of conduct of business rules.

Collectively, although different events, the global financial crisis and the collapse of the Equitable Life company further exposed several weaknesses in the UK's financial sector

regulatory regime. The latter has culminated in the eradication of the FSA and its replacement with the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) which together comprise the ‘contemporary’ Twin Peaks of regulation. In terms of this arrangement, the PRA is largely responsible for micro-prudential regulation while the FCA is generally responsible for the conduct of business and market functions of all financial institutions.

The UK’s regulatory system includes the Retail Distribution Review (RDR) and the implementation of the revised ‘Conduct of Business Sourcebook’ which has been ushered in to improved the quality and suitability of advice given. RDR is clearly market conduct regulation as its objective is to protect concumer insterests. Notwithstanding this, the Financial Advice Market Review (FAMR) may see further regulatory reform and in particular, a number of key aspects of the RDR may be truncated, which once introduced seriously limited advice to the lower end of the market. Goverments and supervisiors are therefore increasingly becoming more involved in insurance regulation. The current position, developing from 1986 onwards, is in stark contrast to the traditionl, historical self-regulatory approach that was underpinned by the Lockean framework.

PART III: EURPOEAN ECONOMIC COMMUNITY (EUROPEAN UNION)

6 EUROPEAN ECOMOMIC COMMUNITY (EEC)

As mentioned above, the development of the EEC and more recently, the European Union (EU), has had a significant influence on the UK's regulatory system. In particular, it has been suggested that European legislation has been a significant driver of much of the regulatory reform that has taken place in the UK and therefore the UK's accession to the EEC (EU) was the catalyst for more intensive and intrusive regulation, as it is known today (Noussia, 2011). Although the preceding sections have focused on the various market conduct events that have resulted in the implementation of market conduct regulation, it is important to bear in mind the various EU Directives that have also resulted in the implementation of market conduct regulation in the UK. As such, a discussion of the EU and its directives form an integral part of the regulatory narrative.

6.1 Formation of the EEC

The EEC was founded in 1957 following the signing of the Treaty of Rome. The EEC is currently referred to as the EU. The purpose of its formation has been to create a single, integrated and liberalised market, including the insurance market, by coordinating the economic policies of its member states (Hogan, 1995; Hess & Trauth, 1998). This endeavour has seen three generations of directives, namely: i) The Freedom of Establishment, ii) The Freedom of Services and, iii) The Single Licence, Home Country Control and the Deregulation of Supervision.[88] This framework for insurance regulation throughout the EU took some 28 years before its full implementation was realised in 1994 (Hogan, 1995). In order to achieve this, a total of 21 insurance regulatory directives have been adopted to ensure that insurance firms can compete freely whilst maintaining an adequate level of financial soundness and consumer protection (Hogan, 1995:337).

The UK joined the EU in 1973[89] (and recently decided to exit) thereby acceding itself to a series of initiatives to achieve a homogenous regulatory system across member states (Ford,

[88] Consult Hess & Trauth (1998:91) for a more comprehensive an analysis of each generation of directives.

[89] The founding members of the EU are Belgium, France, the Netherlands, Italy, Luxembourg and West Germany. Demark, Ireland and the UK joined in 1973 (Hogan, 1995).

2011). However, by 1973, a number of directives had already come into force. These are the First Non-Life Insurance Directive and certain other insurance edicts (1964 Reinsurance Directive and the 1972 Motor Insurance Directive) had been implemented (Hogan, 1995; Ford, 2011). The 1973 Non-Life Directive sought to establish a common solvency regime "to underpin mutual recognition of supervisory systems" (Daykin & Cresswell, 2001:3). In order to continue to write business, insurance firms were required to maintain an adequate excess of assets over liabilities, referred to as the solvency margin[90] (Daykin, 2001:3). In the event that assets over liabilities fell below the required minimum solvency margin, the so-called 'host country supervisor' could impose its own requirements such as requiring the preparation and implementation of a plan to restore the firm to a sound financial position (Daykin & Cresswell, 2001). It makes sense that when insurance companies operate across international and state borders, that the solvency requirements be governed by the "home" country or state. On the other hand, it also makes sense that market conduct be regulated within each state. In the global village in which society now operates, it also makes sense to have international standards to obviate the having of hundreds of different standards to which the international company ought to comply.

EU directives require that member states incorporate directives into their national regulatory systems and laws within a specified time frame (Hogan, 1995:331). Furthermore, EU directives often allow member states to implement 'super equivalent' or higher standards through their domestic legislature[91] (Smethurst, Heukamp, Goodliffe & Miller, 2011). As such, and under the terms of their accession, the UK was required to implement said directives into its domestic legislative framework. This was done in the first instance by virtue of regulations made under the European Communities Act of 1972 prior to it becoming a member state (Ford, 2011:262). Accordingly, the impetus for the 1972 Act was the need to implement the First Directive into the UK's regulatory regime, in terms of which national safeguards were to be harmonised in order to protect both members and third parties (Farrar & Powles, 1973). In particular, Section 2(1) of the UK's European Communities Act reads:

> All such rights, powers, liabilities, obligations and restrictions from time to time created or arising by or under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in

[90] For a more comprehensive review of minimum margins of solvency, see Daykin and Cresswell (2001).

[91] This is often referred to as 'gold-plating' the directive. Member states may not however implement lower standards than those set by the respective directive (See Smethurst *et al*., 2011).

> accordance with the Treaties are without further enactment to be given legal effect or used in the United Kingdom, shall be recognised and available in law, and be enforced, allowed and followed accordingly; and the expression "enforceable Community right" and similar expressions shall be read as referring to one to which this subsection applies.

In addition to this, Section 2(2) provides that any designated Minister or department may, for the purposes of implementing EU obligations, make orders, rules, regulations or secondary legislation. This is further emphasised in Section 3(1) of the 1972 Act which states that in order to incorporate EU directives into the national regulatory system, "a Minister of State may make regulations for enabling Section 2 of this Act to have full effect". As a result of this, government had willingly accepted some "enhanced regulation to the extent necessary to make the [EU's] market liberalising measures effective" (Ford, 2011:251). The Insurance Companies Act of 1981 and the "consolidating" Insurance Companies Act of 1982 thereafter "transposed the First Life Directive of 1979 into UK law" (Ford, 2011:262).

Smethurst *et al*. (2011:363) note that EU directives are the source of much conduct of business rules. In particular, the Directive on misleading advertising (84/450/EEC), the Unfair Contract Terms Directive (93/13/EEC), the Investment Services Directive (93/22/EEC), the Unfair Commercial Practices Directive (2005/29/EC), the Consolidated Life Assurance Directive (2002/83/EC), the Insurance Mediation Directive (2002/92/EC) and the Markets in Financial Instruments Directive (2004/39/EC) have further applied a number of 'conduct of business' rules to the insurance market. These directives are discussed below.

6.2 European Union directives

6.2.1 Directive on misleading advertising

According to Article 1 of the Directive on misleading advertising, the object of said Directive is to "protect consumers, persons carrying on a trade or business or practising a craft or profession and the interests of the public in general, against misleading advertising and the unfair consequences thereof". According to the Directive, misleading advertising can be defined as:

> Any advertising which in any way, including its presentation, deceives or is likely to deceive the person to whom it is addressed or whom it reaches and which, by reason of its deceptive nature, is likely to affect their economic

> behaviour or which, for those reasons, injures or is likely to injure a competitor.

As such, Article 4(1) of the Directive requires that Member States ensure that adequate and effective mechanisms exist for the control of misleading advertising in the interests of consumers as well as competitors and the public in general. Such sentiments were thereafter further echoed in the Misleading and Comparative Advertising Directive (2006/114/EC) in terms of which promotions should be fair, clear and not misleading.

6.2.2 Unfair Contract Terms Directive

The Unfair Contract Terms Directive nullifies any unfair contract terms and further requires that they be drafted in plain and intelligible language (European Commission, 2014a). In fact, Article 6(1) of the Directive provides that "unfair terms… shall… not be binding on the consumer and that the contract shall continue to bind the parties upon those terms if it is capable of continuing in existence without the unfair terms". This provision is supported by a list of terms that could be regarded as unfair to the consumer. A list of these terms is included in Annexure 1.

However, this principle of "Treating Customers Fairly" had already been adopted into the UK's legislative framework prior to the implementation of the Unfair Contract Terms Directive. That is, the UK's Unfair Contract Terms Act of 1977 sought to limit the extent of civil liability for breach of contract, negligence or other breach of duty which could be avoided by means of contract terms and otherwise. Nonetheless, said legislation excluded insurance contracts from its scope and was criticised for its numerous inadequacies and its inaccurate title and accordingly, the implementation of the Directive provided an opportunity to deal with these shortfalls (Dean, 1993). Accordingly, the Directive was thereafter further transposed into the UK's regulatory framework by virtue of the Consumer Contracts Regulations of 1999 and later by way of Principle 6 under the FSA's conduct of business rules.

6.2.3 Services Directive

The EU's Investment Services Directive (ISD) intended to provide "certain guiding principles for [the] adoption of conduct-of-business rules by the host state" and for that reason the Directive never developed a common, specific and detailed set of minimum

conduct of business rules. Rather, in lieu of specific and detailed rules, the Directive provided seven principles which member states were required to incorporate into their national frameworks (Warren, 1995: 206). According to the Directive, a firm must:

- Act honestly and fairly when conducting its business activities and in the best interests of its clients and the market;
- Act with due skill, care, and diligence;
- Employ the resources and procedures necessary for the proper performance of its business activities;
- Obtain from its clients information as to their financial position, investment experience and objectives;
- Make adequate disclosures of relevant material information in its dealings with clients;
- Avoid conflicts of interest and, when they exist, ensure the clients' fair treatment; and
- Comply with all regulatory requirements applicable to its conduct of business.

Furthermore, according to Article 11 of the ISD, member states were required to implement rules of conduct that at least incorporated the principles listed above. This, however, resulted in varying and fragmented systems across member states and accordingly, gave rise to a "compliance nightmare" (Avgouleas, 2000). Steel (1993 as cited in Warren, 1995) pointed out that firms struggled to familiarise themselves with the different rules of various member states and consequently, this warranted the need for a harmonised set of conduct of business rules. In fact, the Forum of European Securities Commissions (2001:6) noted that:

> The present diversity of conduct of business regimes may hinder not only the freedom which investment firms have to provide services throughout Europe but also the provision of an adequate level of protection to European investors. It is therefore necessary to undertake a process of convergence in this field, both to ensure a level playing field for investment firms and to foster public confidence in the operation of the single market in financial services.

As a result of these difficulties and the defects with the ISD, the EU legislator was forced to re-evaluate the "old minimum harmonization measure" (Cherednychenko, 2011). The latter, culminated in the adoption of a 'conduct of business rules' type directive (Warren, 1995: 207). This came in the form of the Markets in Financial Instruments Directive (MiFID) which replaced the ISD and provided a comprehensive set of conditions regulating the relationship between a firm and its client (Schoenmaker, 2013). This framework comprises a set of conduct of business rules, best execution and client order handling requirements, regulations regarding inducements and conflict of interest provisions (Schoenmaker, 2013:361). The MiFID will be discussed in greater detail later.

6.2.4 Unfair Commercial Practices Directive

The Unfair Commercial Practices Directive provides common rules that will provide consumers with protection against "unfair practices and rogue traders" (European Commission, 2007). This includes misleading advertising and sales practices, aggressive marketing behaviour and unfair claims handling (European Commission, 2007). In fact, the Directive defines a number of prohibited "sharp practices" namely, pressure selling, misleading marketing and unfair advertising (Mäntysaari, 2010:127).

6.2.5 Life Assurance Directive

The Consolidated Life Assurance Directive provides certain minimum conduct of business requirements that ought to be transposed into national legislative frameworks (Smethurst *et al*., 2011:363). According to the European Insurance and Occupational Pensions Committee (2010:5), the Life Assurance Directive aims to protect consumers by enabling them to make informed choices. This appears to be the case since the Directive requires that should a consumer "profit fully from a wider and more varied choice of contracts, they must be provided with whatever information is necessary to enable them to choose the contract best suited to their needs" (European Insurance and Occupational Pensions Committee, 2010:5).

6.2.6 Mediation Directive

The Insurance Mediation Directive (IMD/IMD1) which replaced the Insurance Intermediaries Directive (77/92/EEC), provides certain minimum standards that ought to be adhered to by insurance intermediaries. In particular, these standards apply to a number of insurance

mediation activities, such as, sales transactions, dealings with and/or for clients, advice and assistance with claims (Smethurst *et al*., 2011: 363). According to Article 4 of the Directive, a registered intermediary must: i) meet standards of knowledge and ability, as determined by domestic law, ii) be of good repute, with a clean police record and not have been previously declared bankrupt and iii) carry professional indemnity insurance. Furthermore, the IMD1 stipulates a number of obligations regarding: the quality and the nature of advice given, the provision of information to customers, disclosure requirements and the steps to be taken to identify, prevent, manage and disclose conflicts of interest (Merkin & Stuart-Smith, 2004; Braunwarth, Buhl, Kaiser, Krammer, Röglinger & Wehrmann, 2009; Norton Rose Fulbright, 2012). More specifically, the Directive asserts that:

> Prior to the conclusion of any specific contract, the insurance intermediary shall at least specify, in particular on the basis of information provided by the customer, the demands and the needs of that customer as well as the underlying reasons for any advice given to the customer on a given insurance product.

In addition to this, an independent intermediary is required to give independent advice based on an analysis of a sufficiently large number of insurance products available in the market (Domaradzka, 2012). This Directive was eventually implemented into the UK's national legislation by virtue of the Financial Services and Markets Act 2000, as discussed above.

Harmonisation difficulties, similar to those encountered under the ISD were also characteristic of EU mediation regulation. This was accompanied by large-scale negativity surrounding the insurance industry prior the financial crisis, the revelation of a number of unfair business practices in the insurance sector (namely the provision of improper advice and an insufficient disclosure of information to customers) and controversies regarding brokers' commissions, which collectively cast light on undesirable business practices and potential conflicts of interest (Domaradzka, 2012:21; European Commission, 2014b). Furthermore, the regime introduced under IMD and IMD1 "lacked clear and efficient conduct of business and conflict of interest rules and thus could not ensure transparent selling processes and prevent [the] mis-selling of products" (Domaradzka, 2012:21). Moreover, the European Commission (2014b) has pointed out that since the Directive is applied differently among member states, a fragmented EU market and significant inconsistencies have ensued. As a result of this, a number of consumers have frequently been sold unsuitable insurance products. The most widespread example of this is the UK's pension mis-selling scandal.

Consequently, the EU legislature has been urged to revise the current IMD1 regime. This has been achieved following the implementation of the MiFID but subsequent proposals for IMD2 have also been made. Said proposal was tabled in July 2012, and pointed out that IMD2 would endeavour to expand the scope of consumer protection. A number of the provisions recommended under the draft directive are modelled on various provisions that are set out by the MiFID, as discussed below. In fact, the European Parliament requested that IMD2 meet the same consumer protection standards as MiFID in order to achieve "cross-sectoral consistency"[92] (Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, 2012).

IMD2 seeks to upgrade consumer protection by establishing a common set of standards concerning the sale of insurance products and the provision of proper advice. More specifically, the proposal for the new directive noted that the IMD2 would aim to achieve the following improvements:

- Expand the scope of application of IMD1 to all distribution channels (including the direct sale of insurance products by insurers that are not covered under IMD1)
- Identify, manage and mitigate conflicts of interest;
- Raise the level of harmonisation
- Enhance the suitability and objectiveness of advice;
- Ensure sellers' professional qualifications match the complexity of products sold; and
- Simplify and approximate the procedure for cross-border entry into insurance markets across the EU.

The Proposal further provides that Chapter VI of the new directive will not only restate several disclosure requirements that appear under IMD1 but will also set out numerous additional information requirements and conduct of business rules, some of which include:

[92] This appears to be the case since although MiFID applies to the financial sector as a whole, insurance business remains regulated largely by IMD.

- A general principle for intermediaries who should act honestly, fairly and in the best interest of their customers;

- A requirement to disclose the basis and amount of the remuneration/commission to insurance intermediaries;

- A requirement to disclose the amount of any variable remuneration (i.e. sales incentives) received by the sales employees of insurance undertakings and intermediaries;

- A mandatory 'full disclosure' regime for the sale of life insurance products and an 'on–request' regime (i.e. on customer's demand) for the sale of non-life products; and

- An obligation on insurance undertakings and intermediaries to give the customer, prior to the conclusion of a contract, sufficient information about the insurance product to allow him to make an informed decision.

The object of the above mentioned draft provisions is to: i) achieve higher consumer protection, ii) offer higher transparency in terms of the nature, structure and the amount of the intermediary's remuneration as compared to IMD1, iii) ensure suitable, cost-efficient products and intermediary services for consumers, iv) drive competition in insurance distribution (since consumers will have greater information on products and costs, as well as possible conflicts of interest because of the proposed information disclosure requirements) and, v) enable consumers to compare insurance covers and prices between products sold through different distribution channels.

At the time of writing, the proposed IMD2 has yet to be implemented.[93] In fact, the most recent development on the proposed new IMD2, took place on 7 November 2014 at which time the EU Council confirmed its acceptance of the general approach to IMD2. The draft directive will soon see its first reading.

[93] It has been cited that IMD2 may be incorporated into EU legislation at some point in 2014 and thereafter transposed into Member States' domestic legislature in 2016.

6.2.7 Markets in Financial Instruments Directive (MiFID)

As mentioned above, the "compliance nightmare" associated with an un-harmonised EU regulatory system under ISD, eventually led to dramatic and large-scale reforms as part of the EU's 'Financial Services Action Plan' (Cerini, 2011). This resulted in the implementation of the Markets in Financial Instruments Directive (MiFID) (Moloney, 2014). Said Directive introduced a comprehensive and harmonised strategy toward conduct of business regulation and, in doing so, introduced a number of 'conduct of business' provisions.

Article 11(6) of the ISD required that investment firms avoid conflicts of interest, however when such conflicts of interest cannot be avoided, firms should ensure that their clients are treated fairly (van der Haegen, 2004). This obligation was very broad and lacked the necessary detail. As a result of this MiFID reinforces this duty by virtue of Article 18 which reads:

> (1) Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof.
>
> (2) Where organisational or administrative arrangements made by the investment firm in accordance with Article 13(3) to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

In order to ensure uniform application of the principles listed above, the Commission adopted a number of measures to:

> (a) Define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and/or disclose conflicts of interest when providing various investment and ancillary services and combinations thereof; and
>
> (b) Establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm.

In addition to this, MiFID has introduced several other 'conduct of business' responsibilities as set out in Article 19 of the Directive. In terms of Section II, Article 19, a firm is required to:

- Act honestly, fairly and professionally in accordance with the best interests of its clients

- Provide all information, including marketing communications, addressed by the investment firm to clients or potential clients in a fair, clear and non-misleading manner

- Provide appropriate information in a comprehensible form to clients or potential clients so that they are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis

- Obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives, to be done when providing investment advice or portfolio management so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him. This is the so-called "suitability assessment"

- Ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client. The latter is referred to as the "appropriateness assessment". Should the product or service be deemed inappropriate for the client or potential client, the investment firm shall warn the client or potential client

- Establish a record that includes the document or documents agreed between the firm and the client that sets out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client

Article 21 of the Directive strengthens the 'best execution rule' and requires that firms execute orders on terms that are most favourable to the client. In doing so, member states are required to take all reasonable steps to obtain the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. This should be done in a prompt, fair and expeditious manner, according to Article 22 of the Directive.

In October 2011, the European Commission tabled proposals to revise MiFID and thereby proposed MiFID II and the Markets in Financial Instruments Regulation (MiFIR). It was cited in the proposal for the new regime that the financial crisis had exposed several weaknesses in the regulatory system and accordingly that "previously held assumptions that minimal transparency, oversight and investor protection… [are] more conducive to market efficiency no longer hold". In addition to this, the rapid innovation and growing complexity in financial instruments has emphasised the importance of up-to-date, high levels of investor protection. Accordingly, the revision of MiFID has signalled that EU's intention to create a safer, sounder, more transparent, integrated, efficient and competitive EU financial market.

According to Article 23 of the proposed new Directive, a firm is required to take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, (including their managers, employees and tied agents, or any person directly or indirectly linked to them) and their clients in the course of providing any investment and ancillary services, or combinations thereof. Moreover, Section 2 of the recommended new Directive sets out a number of provisions to ensure investor protection. In terms of these provisions, a firm is required to:

- Act honestly, fairly and professionally in accordance with the best interests of its clients

- Ensure that financial instruments are designed and manufactured to meet the needs of an identified target and that the strategy for distribution of the product is compatible with the identified target market

- Understand the financial instruments they offer or recommend, assess the compatibility of the financial instruments with the needs of the clients and ensure that

financial instruments are offered or recommended only when this is in the interest of the client

- Provide appropriate information in good time to potential clients on matters concerning the product, proposed investment strategies and all other related costs and charges

- Disclose whether or not the advice given is provided on an independent basis and on a broad or a more restricted analysis of different types of financial instruments

- Provide appropriate guidance and warnings on the risks associated with products offered or in respect of particular investment strategies associated thereto

- Provide information in a comprehensible form in such a manner that potential clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis

- Assess a sufficiently large range of financial instruments available on the market which must be adequately diverse with regard to both their type and product providers to ensure that the client's investment objectives can be suitably met. The latter applies where a firm informs a client that the investment advice is provided on an independent basis

- Disclose to a client the existence, nature and amount of the commission payable in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service

- Ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. In particular, it shall not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs

- Ensure that persons giving advice or information to clients on behalf of the investment firm possess the necessary knowledge and competence to fulfil their obligations (and the requirements discussed hereunder)

- Obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the product that is suitable for him and, in particular, that is in accordance with his risk tolerance and ability to bear losses

- Ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client. Where the investment firm considers, on the basis of such information received, that the product or service is not appropriate to the client or potential client, the firm shall warn the client or potential client.

- Provide the client with a statement on suitability specifying the advice given and how that advice meets his preferences, objectives and other characteristics.

- Take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

- Execute orders on behalf of clients in a prompt, fair and expeditious manner

- Monitor the activities of their tied agents so as to ensure that they continue to comply with this Directive when acting through tied agents

In addition to the provisions listed above, MiFIR sets out various disclosure and reporting requirements, the object of which is to further enhance transparency in the market. A

discussion of these provisions is however beyond the scope of this paper.[94] According to the UK's Financial Conduct Authority (2014a), it is believed that MiFID II and MiFIR will be implemented into national legislative frameworks by January 2017.

6.3 Conclusion

This section maps out the history of the EU directives insofar as they concern market conduct or conduct of business regulation. It has been argued that many of the regulatory developments that have taken place in the UK have been in an effort to transpose a number of significant EU Insurance Directives into the national legislative framework following its accession to the EU in 1973.

Of the 21 insurance directives that have been adopted over a 28 year period in order to achieve a homogenous regulatory system across member states, six have been the source of many conduct of business rules. These include the Directive on misleading advertising (84/450/EEC), the Unfair Contract Terms Directive (93/13/EEC), the Investment Services Directive (93/22/EEC), the Unfair Commercial Practices Directive (2005/29/EC), the Consolidated Life Assurance Directive (2002/83/EC), the Insurance Mediation Directive (2002/92/EC) and the Markets in Financial Instruments Directive (2004/39/EC). These Directives have collectively attempted to ensure that i) adequate and effective mechanisms are in place, ii) unfair trade practices are eliminated, iii) firms conduct their businesses in the interests of consumers (and thus conflicts of interests are avoided), iv) insurance intermediaries deal fairly and honestly with consumers and v) the best advice is provided and certain disclosures are made. These objectives largely attempt to ensure that an adequate degree of consumer protection is achieved and that consumers are treated fairly.

As noted above, the abovementioned EU directives that are market conduct in nature have had a strong bearing on the development of market conduct regulation in the UK. For example, the noteworthy MiFID's provisions have been enshrined in the UK's conduct of business rules and regulations by virtue of FSMA 2000. Therefore, and as mentioned earlier, the UK's accession to the EU has been pivotal in the history of the British insurance market

[94] See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0600 for a list of reporting requirements.

regulatory regime and has fundamentally influenced the nature of financial services regulation, including that which is market conduct in nature.

The proposal for the new regime, in terms of MiFID II and MiFIR, has largely been in response to the financial crisis which exposed several weaknesses in the current regulatory system. The need for up-to-date rules and regulations in response to global changes and the increasing need for improved investor protection have therefore largely been reactive in nature. Time only will tell what impact the proposed new MiFID II and MiFIR will have on the domestic legislative framework and the insurance market alike. Notwithstanding this, EU Directives have been promulgated in an effort to achieve harmonisation. One can argue that the benefits derived therefrom may be in the public interest in general.

7 UNITED STATES

The development of the insurance market in the US[95] dates back to the late 16th century after which time insurance regulation began to emerge. The development of insurance regulation in the US can be divided into three broad periods which have been divided by landmark events in regulation. These periods include:

i. Pre-1944: developments before the South-Eastern Underwriters Association (SEUA) decision;

ii. 1944-1947: developments since the SEUA decision and the passing of the McCarran-Ferguson Act;

iii. Post-1947: developments subsequent to the passing of the McCarran-Ferguson Act

Each period and their various regulatory landmarks are discussed in detail below, with a specific focus on market conduct regulatory-type developments. In addition to this, a brief history of the American insurance market and its early regulatory landscape are discussed in order to provide a comprehensive narrative. The South African insurance market and its regulatory systems largely have been unaffected by the development of insurance regulation in the US. It is for this reason that a shorter discussion of the US market is sufficient.

7.1 Pre-1944 regulatory developments

7.1.1 Rise of the insurance market in Colonial America

In 1730, a major fire erupted in Philadelphia which threatened to engulf the entire city and which destroyed numerous shops and homes (Athearn, 1981). The city was entirely unprepared to fight the persistent danger of fires and accordingly, the risk of a massive and citywide inferno remained. Following another fire, a letter was sent to the Philadelphia

[95] Colonial America prior to 1776.

Gazette in February 1735 which contained advice and reforms in terms of fire prevention and extinguishing methods and which recommended the formation of a "society of active men belonging to each fire engine, whose business is to attend all fires whenever they may happen" (White, 1998:1). It was on the basis of this advice, that the city formed its first fire-fighting organisation (Block, 2004). It would soon turn out that the author of the letter was Benjamin Franklin who, amongst other things, would go on to establish America's first organised fire brigade, the Union Fire Company, in 1736 (Warheit, 1970).

Despite the fact that Franklin had made significant progress in fire prevention and on the methods of extinguishing them, he acknowledged that not all fires could be prevented and as such, citizens could still sustain property damage and loss (White, 1998). In a meeting of the Union Fire Company, Franklin therefore proposed the idea of forming an insurance company to provide for such a contingency (White, 1998). A fund was thereafter raised "for an Insurance Office to make up the damage that may arise by fire among this Company" (White, 1998:2). In terms of this approach, members of the fire company would be indemnified in the event of property damage or loss caused by fire. The insurance programme was a year, thereafter extended beyond the fire company members, to all citizens of Philadelphia. In particular, a notice appeared in Franklin's Gazette in 1751 as follows:

> All persons inclined to subscribe to the articles of insurance of houses from loss of fire, in or near this city, are desired to appear at the Court House, where attendance will be given, to take their subscriptions, every seventh day of the week, in the afternoon, until the 13th of April next, being the day appointed by the said articles for electing twelve directors and a treasurer.

The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire therefore became the first mutual American property insurer which was incorporated under a royal charter from the Crown in 1752[96] (Porter, 2008). Notwithstanding this, '*The Contributionship'*, as it is known today, remained the nation's only fire company between 1752 and 1784 (White, 1998). The idea of insurance took some time to mature and was therefore a relative latecomer to the American financial landscape (White, 1998).

[96] At the time of this formation, insurance companies had to obtain a royal charter in order to legitimately write insurance business since America was still under British colonialism.

7.1.2 State regulation of the insurance market

America declared its independence in the July of 1776, resulting in the War of Independence, at the end of which America gained its independence as a Constitutional Republic. The powers resided within the states from which insurers received charters in which they operated (Harrington, 2000; Schneider, 2007). The republic which emerged from the war was arranged on a federal basis with most of the powers residing with the states. In 1792, Pennsylvania became the first state to charter insurers after which, in time, most other states followed suit (Porter, 2008).[97] As a result of this, a number of chartered insurance companies came into existence. It was at this time, during the early years of the US that states occasionally endorsed insurance regulation which sought to address various problems concerning competition, consumer protection and solvency (Wachter, 2013). In particular, by the early 1800s, states had begun to feel the pressure to protect their domestic insurers from foreign insurers, particularly British insurers who were entering the US domestic insurance market, and who were competing by charging lower rates than local insurers (Porter, 2008). In response to this, some states passed laws which prohibited such foreign insurers from writing business in the state (Porter, 2008).

In addition to this, US domestic insurers themselves were subject to the regulation of the states in which they obtained their charters and in which they conducted their business. Such state regulation was thus conducted through corporate charters which placed certain limitations and restrictions on insurers' operations (Harrington, 2000; Stempel & Knutsen, 2016). These charters therefore served as the primary legislative device by detailing what an insurer could and could not do regarding policies, risks and investment activity, among other things (Klein, 1998; Stempel & Knutsen, 2016:46). It appears as if such regulation was in response to a number of problems in the property insurance and life assurance markets. In particular, owing to the high concentration of risk and the occurrence of a number of major fires, periodic shakeouts and insurance failures plagued the property insurance market (Klein, 2009:32). Furthermore, life assurers became known for "high expenses, shaky finances and abusive sales practices" (Klein, 2009:32).

[97] The Insurance Company of North America became the first state-charted company by Pennsylvania (Stempel & Knutsen, 2016)

By the mid-1800s, there was a trend toward "less specific charters" and a greater drive toward regulation by state statutes and/or regulation by judicial decision (Stempel & Knutsen, 2016:46). As a result of this, the early years of insurance regulation were conducted by corporate charters, state legislatures and judicial decisions (Mayhall, 2011). In addition to this, various officers within state governments were tasked with overseeing insurance regulation (Porter, 2008). Notwithstanding this, albeit that various regulatory mechanisms existed during this time, US domestic insurers were in fact subject to little regulatory supervision (US Treasury Department, 2008). As such, over time, these early regulatory mechanisms eventually proved inadequate and as the number of insurance companies escalated, the need for greater oversight became apparent (Klein, 1998). This led to the formation of state insurance commissions[98] in the mid-1800s (Klein, 2009; Stempel & Knutsen, 2016). America thus anticipated the UK by over a century with the appointment of bureaucratic supervisors.

A more comprehensive regulatory system thus emerged with the development of state insurance commissions, to oversee the insurance industry within each state (Stempel & Knutsen, 2016). Since the US is a federal system this was inevitable since insurers would operate across state lines encountering problems other countries only began to encounter when insurers attempted to operate across country boarders. The first state commissioner of insurance was appointed in New Hampshire in 1851 and the state-based insurance regulatory system quickly grew (Mayhall, 2011). In particular, Massachusetts and Vermont followed suit in 1852, New York in 1859 and Rhode Island in 1865 (US Treasury Department, 2008:62). These state insurance commissions soon became the first dedicated regulatory agency to oversee insurance regulation. Broadly speaking, the major activities that are regulated by the state insurance department are set out in table 1 below.

[98] Also known as a state insurance department.

Table 1: Overview of regulated activities by state insurance commissions over the years[99]

Activity	Description	Regulatory Pillar
Licencing of insurers, agents/ brokers	This entails the granting, renewal, and revocation of licences to conduct business to ensure that the applicant has adequate financial resources (i.e. a minimum level of capital and reserves) and those office bearers have the minimum level of competencies and trustworthiness. Furthermore, insurance agents and brokers must be licenced in order to sell insurance and must comply with various state laws and regulations which govern their activities. This is done to protect insurance consumer interests in insurance transactions.	Market conduct regulation
Insurer solvency	Solvency monitoring by state insurance departments includes the development of capital and financial reporting requirements, investment regulations, holding company regulations and guarantee funds.	Prudential regulation
Rates	Regulators endeavour not only to ensure that policy benefits are commensurate with the premiums charged to ensure fair treatment of consumers but also ensure that premium rates are adequate in order to reduce the risk of insolvency. Historically, many states have subjected premium rates to the "prior approval" system. As it stands today, some states use a more competitive rating approach.	Prudential regulation
Content of policy forms	State insurance departments enforce legislation dealing with market conduct and unfair trade practices to ensure consumer protection. In doing so, state regulators endeavour to ensure that insurance policy provisions comply with the relevant state law, are reasonable and fair, and do not contain major gaps in coverage that might be misunderstood by consumers and which may leave them unprotected.	Market conduct regulation
Insurer sales practices and	Regulation of sales practices through state insurance department enforcement of market conduct / unfair trade practices legislation; required disclosure of price information; production and dissemination of information about prices and quality by regulators.	Market conduct regulation

[99] As extracted from Harrington (2000) and NAIC (2011).

information disclosure		
Consumer assistance	State regulators have established toll-free hotlines, internet sites and special consumer services units to receive and handle complaints against insurers and agents in order to ensure consumer protection.	Market conduct regulation

Over the years, insurance commissions' mandates and their responsibilities grew in scope and complexity as the insurance industry evolved (Klein, 2009). Insurance commissions were therefore (and for the most part still are) tasked with, amongst other things, the licencing of insurance companies and their agents, the regulation of policy forms, the setting of reserve requirements, the regulation of insurers' investments and the administration of financial reports (Klein, 1998:173).

Insurance commissions generally have "broad, legislatively delegated powers to enforce state insurance laws, [to] promulgate rules and regulations, and [to] conduct hearings to resolve disputed matters" (Randall, 1999:629). In other words, and as per the state insurance commission mandate, state insurance departments have the authority to implement legislative directives (as set out in the state insurance code) and to establish rules and procedures that governed the purchase and sale of insurance (Harrington, 2000; Harrington & Niehaus, 2003). The aforementioned regulatory activities can be divided into two primary regulatory categories. These include prudential or solvency regulation, which seeks to protect policyholders from the risk that an insurer will go insolvent and be unable to meet future, potential financial obligations, and the more recently introduced market conduct regulation which aims to ensure fair and reasonable prices, products and trade practices (Klein, 1995: 368).

Of particular relevance to this research, is a discussion of the various market conduct regulatory systems that have existed in the market. The regulation of policy rates and contract wordings falls typically within the realm of market conduct regulation, and hence warrants further discussion. It is this early regulation of premium rates and policy wordings by state insurance departments that signals the early development of market conduct regulation in the market. For chronological purposes, however, these developments are discussed in section 7.2 below.

7.1.3 State versus Federal regulation debate

Owing to the federal nature of the US, insurance is essentially a state matter. It was accepted that the federal government had a very limited mandate to regulate insurance. In recent years there have been attempts to move insurance regulation from states to federal government. The tension between the federal government and state government departments over insurance regulation began to emerge during the mid-1800s (Grace & Klein, 2000). A number of insurers requested increased federal intervention in the insurance regulatory realm because of alleged favouritism (or localism) by some state departments (Stempel & Knutsen, 2016). In addition to this, state insurance regulation varied with degrees of regulatory authority, as state insurance departments developed their own set of insurance regulations and rules (US Treasury Department, 2008; Mayhall, 2011). As a result of this, multi-state insurance companies who were operating across state lines were subjected to different regulatory systems across states (Mayhall, 2011). Accordingly, the insurance industry and various other stakeholders "joined a growing movement for federal insurance regulation" which was presumed to be weak in order to avoid burdensome multiple state regulations which tended to be more aggressive (Mayhall, 2011: para 3: Randall, 1999).

In response to this, a number of Bills were introduced to the US Congress in the 1860s that sought to create a federal agency that would regulate insurance matters (Harrington, 2000). Although none of these Bills were ever enacted, the drive toward federal encroachment on the state based regulatory system continued (Harrington, 2000; Mayhall, 2011). Although at the time there was some support for federal regulation, this was not the prevailing view. These efforts for federal superiority were however thwarted by the US Supreme Court's decision in *Paul v Virginia* 1869 75 US 168 which addressed the rivalry between state–based regulation and federal regulation of the insurance market. The *Paul v Virginia* case was therefore a seminal development in the federal-state regulatory debate that has been characteristic of the regulation of the US insurance market. The facts of the aforementioned case are set out below.

7.1.3.1 Paul versus Virginia (1869)

Several New York based insurance companies hired Samuel Paul as an intermediary to place their business and to represent them as an agent in the state of Virginia. Thus the issue was one of cross border insurance. Virginia law required that a licencing bond be paid in order to

transact insurance business in the state. Virginia state legislation applied also to Mr Paul, since he wanted to place insurance in the state of Virginia and accordingly although he was an out of state agent for a group of New York fire insurers, he was required to be licenced by Virginia and to pay a security deposit. Despite this however, Mr Paul and the several New York insurers, refused to pay the deposit. To do so, would mean paying a deposit in each state where they placed business. Consequently, Mr Paul was denied a licence to sell insurance in the state but nevertheless continued to operate in the state. He was charged criminally and was consequently convicted of violating Virginia state law and fined. The Virginia Supreme Court affirmed the conviction and echoed the sentiments that Mr Paul had violated Virginia statue. In response to this, Mr Paul argued that Virginia's laws violated the Privileges and Immunities Clause (as prescribed by the Fourteenth Amendment) in the US Constitution and further contended that the sale of insurance across borders constituted interstate commerce and was therefore, by virtue of the Constitution, subject to federal laws and not state laws. In short, the argument was that insurance was a federal and not a state matter.

The matter went to the US Supreme court, which had to decide if insurance formed part of interstate commerce which would therefore make insurance subject to federal legislation. The US Supreme Court held that the "issuing of insurance was not a transaction of commerce" in terms of the Commerce Clause in the Constitution and accordingly that insurance was a state matter and as such state licencing restrictions did not violate the Privileges and Immunities Clause contained in the Fourteenth Amendment (Stempel & Knutsen, 2016). Insurance was therefore a state matter, to be regulated by state laws. Thus, the Supreme Court's decision placed the jurisdiction of insurance regulation directly on the states, much to the disappointment of parts of the industry, which as mentioned before, were calling for greater and a more consistent federal regulation (Randall, 1999).

Albeit that further attempts sought to amend the Constitution by permitting the federal government to regulate the insurance industry, these efforts were thwarted and the Supreme Court maintained its position that insurance regulation was a state matter (Randall, 1999). Despite this however, state regulators themselves began to acknowledge the "national nature of insurance business" and because of this, considerations of regulatory efficiencies were underpinned by talk of federal regulation (Randall, 1999:632). In particular, Elizur Wright

(1865 as cited in Robbins, 1939:321), often referred to as the "Father of [American] Insurance Regulation" noted that

> Insurance, being of widespread interest, should be secure against the adverse operation of local causes-that simplicity required a national bureau, and that a state could probably not protect itself as well with reference to insurance of other states as it could be protected by the federal government.

In response to the ever-growing concerns of individual state regulation, George W. Miller in 1871 and as the New York superintendent of insurance, called all state insurance commissioners to attend a meeting to discuss insurance regulation (Randall, 1999). This would mark the beginning of the National Insurance Convention (NIC) and the start of efforts to coordinate regulatory systems among state departments to ensure uniformity and harmony.

7.1.4 National Insurance Convention (NIC)

As mentioned above, by the mid-1800s, a number of insurers were operating across state lines, and as a result of this were required to comply with varying state demands and regulatory requirements. In response to these issues and in a reaction to the *Paul v Virginia* case, regulators acknowledged the value and necessity of coordinating the regulatory systems of various state departments, with the outcome of a uniform regulatory system specifically in mind (Randall, 1999). As such, and under the direction of George Miller, the regulatory representatives from nine states collaborated to form the NIC in 1871 (to become the National Association of Insurance Commissioners, hereon referred to as the NAIC), which, by its second session, had taken a number of actions (Outreville, 1998). In particular, over time the NAIC i) developed a set of goals and objectives to be achieved by regulators, ii) designed a uniform annual accounting statement form, iii) adopted taxation guidelines for insurance companies and iv) drafted and adopted the first model law on insurance regulation (Porter, 2008; Outreville, 1998). By virtue of these steps, the commissioners noted that they were

> Fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all states-not reciprocal, but identical; not retaliatory, but uniform. That repeated consultation and future concert of action will eventuate in the removal of discriminating and oppressive statutes which now disgrace our codes, and that the companies and the public will both be largely benefited, we have no manner of doubt.

Accordingly, a system was found, outside of federal regulation, to achieve nationwide harmonisation of insurance regulation. The history of the NAIC demonstrates the association's dual and often competing commitments to achieving both uniformity of regulation whilst ensuring the preservation of state regulation. In other words, the goal of uniform and nationalised regulation is inconsistent with the preservation of autonomous state regulation (Randall, 1999:635). This tension is reflected in early proceedings where the NAIC developed the association's objectives and purposes. In particular, the associated noted that

> The object of this association shall be to promote uniformity in legislation affecting insurance; to encourage uniformity in departmental rulings under the insurance laws of the several states; to disseminate information of value to insurance supervisory officials in the performance of their duties; to establish ways and means of fully protecting the interest of insurance policyholders of the various states, territories and insular possessions of the United States; and to preserve to the several states the regulation of the business of insurance.

The NAIC's current Constitution, which was adopted in 1980, almost a century after its establishment, reinforced the longstanding tension which had existed between the NAIC's commitment to the preservation of state regulation and its objective to create a uniform insurance system for multistate insurers. In particular, the Constitution provides that

> The objective of this body is to serve the public by assisting the several State insurance supervisory officials, individually and collectively, in achieving the following fundamental insurance regulatory objectives: (1) Maintenance and improvement of state regulation of insurance in a responsive and efficient manner; (2) Reliability of the insurance institution as to financial solidity and guaranty against loss; (3) Fair, just and equitable treatment of policyholders and claimants.

Item 3 is a clear reference to market conduct regulation. It can thus be argued that the US predated the UK in pursuing market conduct objectives by recognising such a consumer protection ideal. This also reflects the fact that supervisory institutions were introduced earlier in the US, owing to the inter-state insurance transactions, as pointed out earlier. Notwithstanding this, the NAIC's Constitution sets out the basic goals of insurance regulation. In particular, the Constitution notes that the NAIC should endeavour to ensure the solvency of insurers and to protect policyholders. As such, the NAIC itself has also recognised the two important facets of regulation, namely prudential and market conduct

regulation. It is the latter that is far more acute to this research report. A brief discussion of NAIC market regulatory model laws and standards follows in section 7.3 below.

7.1.5 Rating Bureaus and the Sherman Antitrust Act of 1890

The conclusion that insurance is a state matter was reconsidered because of the Federal Antitrust agenda of the late 1800s; this itself was a product of the US Progressive movement of that period. The history of the US property insurance market and, in particular, fire insurance rating and regulation is unequivocally characterised by noncompetition and was dominated by cartels, or tariff committees in the UK terminology (Joskow, 1973). The development of cartels or cooperative fire rate-making bureaus extends as far back as the early nineteenth century when the Salamander Society was formed in 1819 (Wagner, 2000). By this time, the practice of setting rates in concert (through tariff committees) was well established in England. Almost half a century later in 1866, the National Board of Fire Underwriters was established to "maintain uniform premium rates and to control agents' commissions" in order to stabilise the market by preventing competition-induced insolvencies (Joskow, 1973:392). Despite the fact that the Board was established by insurers themselves, over time insurance companies began to violate their membership agreements and engaged in price undercutting (Joskow, 1973). Furthermore, since membership was voluntary, mass participation in bureau rates was difficult (Joskow, 1973). It was these problems which proved the National Board to be unsuccessful and thus this countrywide bureau was discontinued in 1877 (Wagner, 2000).

However soon after 1877, local and regional rating organisations began to emerge which may possibly have been spurred on by the numerous insurer insolvencies as a result of catastrophic fires in Boston and Chicago (Joskow, 1973; Harrington, 2000). As a result of this, greater attention was focused on regulating rates, not only to ensure that they were not unfair, but also to ensure that the rates being charged were in fact adequate to reduce the risk of insolvency (Harrington, 2000). As a result of this, a number of state insurance departments permitted and/or encouraged the establishment of rating bureaus which would set rates to be charged by companies (Harrington, 2000). The latter is clearly of a prudential regulatory nature. These rating bureaus, although they differed in their approach, internalised a number of functions of their predecessor (Wagner, 2000). These rating organisations were however evolving during a time of public dissatisfaction with anti-competitive practices and

monopolies (Joskow, 1973; Wagner, 2000). As a result of this, Congress passed the Sherman Antitrust Act in 1890 which prohibited anticompetitive practices. The passing of the Sherman Antitrust Act gave a number of states the impetus to pass their own antitrust legislation which ultimately prohibited the making of rates in concert.

By 1913, twenty three states had enacted anticompetitive laws to combat price fixing and by implication, rating bureaus soon became illegal (Wagner, 2000). Despite this, it has been alleged that state antitrust legislation did little to deter rate setting (Wagner, 2000). More specifically, insurers are alleged to have agreed to uniform rates over dinner at "social clubs" and would shun employees of non-complying insurers (Wagner, 2000). Accordingly, such legislation appears to have been countered.

In 1910, the New York legislature appointed a Joint Legislature Committee, known as the Merritt Committee, to investigate problems in fire insurance rate making (Joskow, 1973). The Committee concluded that competition exacerbated "rate wars" which were not in the public's interest (Wagner, 2000). As a result of this, the Committee argued that insurers should be able to set rates collectively in order to reduce the expenses incurred in making rates separately (Wagner, 2000). Furthermore, the Committee noted that insurers ought to be able to pool their premium and loss information in order to make credible and appropriate rates (Wagner, 2000). It was upon this basis that the Committee had provided a justifiable rationale for insurers to be exempt from antitrust legislation.

Based on the findings of the Committee, New York passed a law in 1911 which provided for the setting of non-discriminatory fire insurance rates but required rating bureaus to file such rates with the Superintendent of Insurance (Joskow, 1973). A number of states conducted their own investigations (in line with the Merritt Committees findings), after which time, general support developed for the setting of rates subject to state regulation (Wagner, 2000). The NAIC also supported this movement to reinstate rating bureaus in order to combat "destructive competition" and to ensure adequate rates (Porter, 2008). Accordingly, states began to repel their antitrust laws and rating bureaus soon began to re-emerge. The relative tranquillity of the bureau system which prevailed after this time would however be dealt a blow in 1944.

7.2 Regulatory developments between 1944-1947

7.2.1 South-Eastern Underwriters Association and the McCarran-Ferguson Act

Following the repeal of state antitrust laws, the number of rating bureaus increased. One such bureau that emerged was the the South-Eastern Underwriters Association (SEUA). During the SEUA's early existence, fire insurance rate setting was subject to state regulation and was exempt from federal laws, including antitrust laws. This position was however challenged in 1942 when the Missouri attorney general filed a complaint with the Antitrust Division of the US Department of Justice and required that they conduct an investigation into the activities of the SEUA (Harrington, 2000). A federal investigation therefore followed which subsequently resulted in a number of criminal indictments against the SEUA for alleged violations of the federal Sherman Antitrust Act. The charges included "restraining and monopolizing commerce, fixing prices and agents' commissions, attempting to force buyers to buy from member insurers, denying non-member insurers access to reinsurance from member insurers, and refusing to transact with agents who represented non-member insurers" (Harrington, 2000:24).

The SEUA argued that not only were their practices beneficial but also that according to *Paul v. Virginia*, insurance was not commerce in terms of the US Constitution and therefore was not subject to federal legislation (Harrington & Niehaus, 2003). The SEUA therefore contended that the Sherman Antitrust Act did not apply to insurance. A US District Court agreed and dismissed the case on the basis of the Supreme Court's decision in *Paul v. Virginia* (Harrington, 2000). On appeal in 1944, the Supreme Court delivered the proverbial fatal blow to the defence when it overturned its 1869 *Paul v. Virginia* decision by holding that insurance is commerce and that it is interstate commerce in terms of the US Constitution when it takes place across state lines (Harrington, 2000). In particular the Court held that

> No commercial enterprise of any kind that conducts its activities across state lines has been held to be wholly beyond the regulatory powers of Congress under the Commerce Clause. We cannot make an exception for the business of insurance.

By implication, the Court therefore held that the activities of rating bureaus were subject to the 1890 Sherman Antitrust Act and that practices which are designed to fix rates are in violation of the Act (Joskow, 1973).

The 1944 decision created tremendous uncertainty since the state-based system of insurance regulation which had long prevailed was now in question. Uncertainty prevailed as to the legitimate scope of state regulation and the legality of industry-operating procedures based on state regulation, particularly those of rating bureaus (Harrington & Niehaus, 2003). In addition to this, the decision threatened state jobs and the insurance market soon became perturbed by this uncertainty (Wagner, 2000). As a result of this, both the insurance industry and state regulators, with the support of the NAIC, sought clarity on these issues from the US Congress which quickly reacted by passing the McCarran-Ferguson Act and thereby restoring the legitimacy of state regulation (Harrington, 2000). The most prevalent sections of the 1945 Act are summarised in table 2.

The implications of the McCarran-Ferguson Act were twofold. First, states regulators would continue to have primary authority for insurance regulation,[100] however the federal government could enact legislation to regulate insurance if state regulation was found to be deficient (Harrington, 2000). Secondly, rating bureaus although collusive in nature, would not be subject to federal antitrust laws, provided they were regulated by the states and did not involve boycott, coercion, or intimidation (Harrington & Niehaus, 2003:103). In 1946 and in response to the McCarran-Ferguson Act, the NAIC drafted two model Bills which sought to

> …preserve the business and regulatory *status quo* and to demonstrate that rate-making, in particular, bureau rate-making, would be quite explicitly 'regulated' by the states. This approach was designed to provide a state regulatory umbrella under which cooperative rate-making by bureaus would be exempt from the Federal antitrust laws.

Most states revised their regulatory systems to conform with the NAIC's model bills (Joskow, 1973). This was done in order to provide greater oversight of rating bureaus so as to stay clear of federal regulation (Harrington, 2000). As such, a number of state laws therefore required that insurance companies receive prior approval of their rates before transacting in the market (Harrington & Niehaus, 2003).

[100] This was further reaffirmed in 1999 following the passing of the Financial Services Modernization Act of 1999 (the Gramm-Leach-Bliley Act) which provided that states would continue to regulate the business of insurance and hence that the McCarran-Ferguson Act remained in effect. Congress however called for state reform in order to allow insurers to compete more effectively (See NAIC, 2011).

Table 2: Excerpts from the McCarran-Ferguson Act of 1945, Chapter 20 (Regulation of Insurance)

Section	Description
1011	Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States
1012	(a) State regulation: The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business. (b) Federal regulation: No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended [15 U.S.C. 41 et seq.], shall be applicable to the business of insurance to the extent that such business is not regulated by State Law.
1013	(a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act [15 U.S.C. 41 et seq.], and the Act of June 19, 1936, known as the Robinson-Patman Anti-Discrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof. (b) Nothing contained in this chapter shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

Such state laws typically required that premium rates were not excessive or unfairly discriminatory (Klein, 1995). Regulating premium rates and contract conditions appears to be market conduct in nature. Initially however, as indicated above, the rationale from an insurer's perspective in terms of colluding on premium rates was to counter "destructive

competition"; this being a solvency issue. What appears to be market conduct on the one hand can also lead to prudential considerations. It is however accepted that the regulation of premium rates and contract terms and conditions at state level are illustrative of market conduct regulation. It can thus be accepted that market conduct regulation existed in the US at a very early date. State appetite for regulation premium rates has been waning. Beginning in the mid-1960s, a large number of states regulators have been discarding the prior approval regulatory system in favour of more competitive rating laws (Harrington & Niehaus, 2003:103).

Similarly, policy forms were also subject to some form of prior regulatory approval to ensure fair trade practices, a market conduct issue (Klein, 1995). In particular, regulators sought to ensure that policy provisions were reasonable and fair and did not contain major gaps in coverage that may have been misunderstood by consumers (Klein, 1995: 374). It therefore follows that during this early period, there was some recognition of consumer protection and market conduct issues by state insurance commissions.

The historical evolution of insurance market conduct regulation in the US continued to develop in the late 1940s when the NAIC adopted various model laws pertaining to unfair methods of competition, unfair and deceptive acts and practices in the business of insurance which all exhibited market conduct regulatory undertones. This was a second albeit more delayed response to the McCarran-Ferguson Act (Wallison, 2000; NAIC, 2011). According to Section 1 of the Act, the purpose is to

> …regulate trade practices in the business of insurance in accordance with the intent of Congress as expressed in the McCarran-Ferguson Act by defining, or providing for the determination of, all such practices in this state that constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined

As such, the Act sets out various activities which are deemed to cause unfair competition or which may amount to deceptive and unfair trade practices. These activities, as specified in Section 3, include:

- Misrepresentation and false advertising of insurance policies
- False information or misleading statement

- Defamation (including those statements which may be derogatory to the financial condition of any insurer)

- Boycott, coercion and intimidation (similar to that which is intended by the Sherman Antitrust Act of 1890)

- False entries

- Unfair discrimination

- Rebating

Following the promulgation of the model bill by the NAIC, most states enacted legislation which mirrored a number of the provisions noted above and which dealt with unfair trade practices by insurers. Although such state legislation has been amended over the years, the core feature of these laws continues to reflect the ethos of the model bill and its objectives that were set in the late 1940s. A discussion of each state's laws in this regard is however beyond the scope of this report. Nonetheless, it can be concluded that the antitrust drive in the US resulted in state regulators introducing a wide range of market conduct regulation matters.

7.3 Regulatory developments post-1947

Historically, insurance regulation in the US has dealt with solvency regulation and market conduct which is often referred to as consumer protection regulation. The evolution of insurance regulation, however, has primarily focused on prudential regulation. Over time, and as indicated above, market conduct issues were also regulated. State insurance departments in the 19th century regulated premium rates and policy wording to ensure fair trade practices. The NAIC drafted model laws pertaining to unfair competition, and deceptive practices.

Amid concerns about the variability of regulatory oversight, the NAIC commissioned McKinsey & Company in 1971 to "review the financial and market conduct surveillance of insurance companies". Following the review, the McKinsey report recommended the establishment of a separate and distinct program of market conduct surveillance which ought to endeavour to:

- Focus on companies engaging in unfair business practices;

- Identify unfair practices through a review of complaints, an examination of company materials and specific transactions, and interviews of agents and company personnel;

- Document the results of market conduct examinations should be done well in a timely, action-oriented report;

- Conduct examinations by specially trained staff, who should understand the applicable laws and regulations for the type of insurance that is the subject of the examination.

In response to the aforementioned recommendations, the NAIC undertook a number of initiatives to improve market conduct regulation. Among other things, this included the establishment of the NAIC Market Conduct Subcommittee and Market Conduct Task Force to review market conduct regulation and make recommendations for improvements through the development of model laws. It can therefore be argued, that although market conduct regulatory attempts had already been made, market conduct regulation only consciously entered the regulatory agenda in the early 1970s when the NAIC undertook its first investigation of market conduct surveillance. It is these two developments which therefore played a significant role in the evolution of market conduct regulation in the US.

Following their investigation, the NAIC established the Market Conduct Surveillance Handbook Task Force whose mandate was to develop market conduct standards. This eventually culminated in the Market Conduct Surveillance Handbook which i) developed a model for market conduct regulatory activities, ii) provided guidance in terms of market conduct examinations and review processes and iii) facilitated the sharing of information across states. Since its adoption in 1975, the handbook (which was later renamed the Market Conduct Examiners Handbook) has been updated and expanded in line with the various market changes that have taken place. Most recently, the handbook was consolidated into the Market Regulation Handbook which serves as a compilation of market conduct examination standards.

Several states adopted their own handbooks which reflected the state's regulatory philosophy and which were in line with the NAIC'S recommendations (NAIC, 2013). Furthermore,

following the recognition of proper consumer protection mechanisms by the NAIC, a number of state regulators responded and passed their own legislation in line with NAIC model laws and regulations. However, in 1999, a follow up study on market conduct oversight was commissioned where it was found a "lack of coordination and communication between states continued to hamper market conduct oversight, and that activities varied significantly from state to state" (NAIC, 2013:12). This was further compounded by the 2003 report by the US Government Accountability Office (GAO) that again raised concerns about market conduct oversight activities. Although the GOA acknowledged that the NAIC had made efforts to improve market conduct regulatory oversight, the progress in implementing these efforts was slow (NAIC, 2013). Accordingly, in response to the report, the NAIC renewed and re-prioritised its efforts to improve market conduct oversight and to develop uniform standards.[101]

Once again, state regulators responded and it was upon NAIC model laws, regulations and guidelines that most states' legislations and regulations have been designed and developed. A summary of the historical development of the most significant NAIC model laws, regulations and guidelines with a strong consumer protection focus are set out in table 3 since a discussion of each state's laws and regulations is superfluous to this report.

Following the 2008 Financial Crisis, Congress passed the Wall Street Reform and Consumer Protection Act of 2010 which is more commonly referred to as the Dodd-Frank Act. At the outset, it appeared as if the Act would once again bring the federal versus state debate to the fore, specifically in terms of insurance regulatory matters. That is, the Act created the Consumer Financial Protection Bureau (CFPB) which, to a large degree, adopted many of the market regulation and consumer protection functions that had developed over time (NAIC, 2011).

Despite the fact that the CFPB was to assume these functions for the financial services sector in its entirety, Congress eventually decided to specifically exclude the regulation of insurance from the wide range of duties and powers of the agency (NAIC, 2011; Kochenburger & Salve, 2011; Kemp, 2015). That is, as per the Dodd-Frank Act, the CFPB has no jurisdiction over the business of insurance and accordingly, market conduct regulation of the insurance market remains under state authority (American Bankers Association, n,d.).

[101] This first step in doing so was through the establishment of the NAIC's Modernization Plan in 2003.

Table 3: Summary of significant NAIC model acts, regulations and guidelines with a strong consumer protection focus

Date	Model law	Description
1948	Unfair Trade Practices Model Act	To regulate trade practices in the business of insurance by defining all such practices that constitute unfair methods of competition or unfair or deceptive acts or practices and prohibiting such practices. In broad terms, the Act prohibits misrepresentation and false advertising, defamation, coercion, and unfair discrimination by insurance companies. The Act also requires insurers to maintain complaints, claims, rating, underwriting and marketing records in a manner that is retrievable for examination by state insurance regulators.
1956	Model Law on Examinations	To establish an effective, efficient system for examining the activities, operations, financial condition and affairs of all persons transacting the business of insurance by authorising the state insurance commissioner to conduct examinations whenever it is deemed necessary.
1972	Unfair Claims Settlement Practices Model Act	To set forth standards for the investigation and disposition of claims. This Act requires insurance companies to promptly investigate claims and settle claims in good faith by effectuating prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear.
1975	Market Conduct Surveillance Handbook[102]	To reflect established practices and to assist each jurisdiction in developing its own market conduct examination procedures.
1987	Long Term Care Model Act	To protect applicants for long-term care insurance from unfair or deceptive sales or enrolment practices, to establish standards for long-term care insurance, to facilitate public understanding and comparison of long-term care insurance policies, and to facilitate flexibility and innovation in the development of long-term care insurance coverage.

[102] Market Conduct Examiners Handbook

1988	Producer Licensing Model Act	To govern the qualifications and procedures for the licencing of insurance producers and provides specific guidance regarding the causes for which a state insurance department may place on probation, suspend, revoke or refuse to issue or renew an insurance producer's licence or levy a civil penalty.
1995	Improper Termination Practices Model Act	To protect policyholders from improper terminations of insurance coverage and to set forth standards for the regulation and disposition of terminations of policies or certificates of insurance.
1995	Life Illustrations Model Regulation	To provide rules for life insurance policy illustrations that will protect consumers and foster consumer education. The regulation provides illustration formats, prescribes standards to be followed when illustrations are used, and specifies the disclosures that are required in connection with illustrations. The goals of this regulation are to ensure that illustrations do not mislead purchasers of life insurance and to make illustrations more understandable.
2000	Privacy of Consumer Financial and Health Information Regulation	To govern the treatment of non-public personal health information and non-public personal financial information about individuals by all licensees of the state insurance department.
2004	Market Conduct Surveillance Model Law	To establish a framework for Insurance Department market conduct actions.
2006-2016 (Updated annually)	Market Regulation Handbook	To serve as a compilation of the market conduct examination standards, including standards pertaining to operations management, complaint handling, marketing and sales, producer licencing, policyholder service underwriting and claims rating

Notwithstanding these limitations, the CFPB has been granted authority over insurance companies in the event that amongst other things they i) provide a "consumer financial product or service" including financial advisory services, loans to policyholders and insurance premium financing, or (ii) are operating as a "service provider" to a "covered person", such as where an insurance industry participant operates as a debt protection contract administrator (Kemp, 2015).

In addition to this, the CFPB has authority to take action against any insurance company if it deems that the insurer has engaged in "unfair deceptive and abusive acts and practices" (Kemp, 2015). The CFPB not only has the ability to determine what constitutes unfair, deceptive and abusive acts and practices, but also has the authority to penalise insurers for such violations (Kemp, 2015).

As it stands today, insurance regulation and specifically that which regulates market activities continues to develop in order to achieve a uniform, balanced and effective system. This is largely in response to the changing nature of the insurance market. Notwithstanding this, it has been suggested that it is unlikely that state regulatory systems will ever achieve the optimal balance of diversity and uniformity in the absence of federal intervention (Biggs & Richardson, 2014). The state versus federal power struggle is therefore likely to endure.

7.4 Economics of US insurance regulation

The point of departure in terms of the economic theory of regulation is self-interest. In a legislative context, legislation can be captured. In other words, legislation may not be passed in the public interest but can benefit the regulated party. Economists approached this from the point of supply and demand. On the demand side, it can be argued there is demand by the public for regulation. That is, public may demand regulation for a better regulated market which may achieve various consumer protection ideals. On the supply side, regulators provide the demanded regulation. The evolution of the US regulatory system as set out above demonstrated the early emergence of market conduct regulation. Initially it was clear that regulation was demanded not by the public but by the insurance market itself. The insurance market adopted collusive policies to ensure higher premiums in order to combat destructive competition which may lead to insolvency. In this respect, such efforts were of a prudential nature.

On the other hand, there appears to be little evidence to support the idea that industry has demanded regulation in terms of which the modern extensive regulatory system has evolved. What is clear is that, over the years, the drafting of legislation has come from the model laws promulgated by the NAIC and not from individual elected state legislators. Elected state legislators have tended merely to adopt the NAIC model laws for well over a century. The NAIC is a committee of bureaucratic regulators who are not elected legislators. This would point to the danger that much of the legislation is exposed to regulatory capture by the regulators themselves. That is, regulators themselves capture the regulatory process for the benefit of themselves.

7.5 Conclusion

The establishment of state insurance commissions, the first of which was founded in 1851 in New Hampshire, brought with it the regulation of a number of market conduct activities. These included the licencing of insurers and agents/ brokers, the regulation of premium rates and policy forms, the provision of consumer assistance and the oversight of insurer sales practices and information disclosures.

Regarding the history of market conduct regulation, the Unfair Trade Practices Act by the NAIC in 1947 is an important development. In terms of this model law, certain activities relating to unfair and deceptive practices were prohibited. The latter falls within the scope of market conduct regulation and therefore signalled a greater regulatory cognisance and more focused approach to consumer protection and market conduct regulation. It is for this reason that one may argue that the genesis of market conduct regulation in the US can be traced back to the mid-1900s, largely in response to the state-federal tug of war.

Notwithstanding these efforts, in the early 1970s, state regulators were accused of focusing almost exclusively on prudential regulation. Although market problems had been identified by state regulators, the McKinsey report concluded that market conduct oversight was inadequate and unorganised. It was for this reason that the review committee recommended the establishment of a distinct and more focused market conduct regulatory programme. Both the NAIC and state regulators responded to these recommendations. Accordingly, although market conduct regulation developed in the mid-1900s, a greater and more focused awareness of market conduct regulatory oversight developed after this time. This culminated in a

number of NAIC model laws, regulations, standards, guidelines and handbooks, most of which were transposed in state regulatory systems.

8 SOUTH AFRICAN INSURANCE MARKET

As mentioned earlier, following the global financial crisis, regulators around the world have demonstrated a propensity for greater intrusive, proactive financial regulation and oversight. South Africa is no different and similarly, the motivation for greater regulatory supervision is rooted primarily in the 2007-2008 global financial crisis. This is somewhat surprising since the South African financial services market emerged largely unscathed by the global financial crisis,[103]

The financial services regulatory landscape in South Africa is in a state of change, largely in response to global trends and in an attempt to keep abreast with international best standards, which have arguably been influenced by the global financial crisis. At present, there are a number of new, amended and proposed regulations for the financial market as South Africa begins to embrace the Twin Peaks regulatory model. Said regulatory developments are discussed in the section below, in addition to a brief outline of the history of insurance and insurance regulation in South Africa.

8.1 Historical overview of the South African insurance market

The development of the insurance market in South Africa is naturally linked to the development of the country and accordingly, both the latter and the former ought to be looked at in conjunction (MacGregor, 2012). For centuries, historians have regarded the arrival of Europeans in the southern region of Africa as the starting point of South African history[104] (South African History Online, n.d.). Furthermore, it appears that the arrival of Jan van

[103] South Africa is said to have experienced little financial upheaval owing to its various policy components. This includes i) a sound framework for financial regulation and well-regulated institutions, ii) appropriate and conservative risk management practices at domestic banks, iii) limited exposure to foreign assets, iv) a robust monetary policy framework, v) a countercyclical monetary policy, and vi) a proactive approach to dealing with bank credit risks (National Treasury, 2011).

[104] Although the history of South Africa can be traced as far back as 6-8million BCE when the early hominids populated South and East Africa (Johnson, 2004).

Riebeeck in April 1652 at the Cape of Good Hope marked the beginning of permanent European settlement in the region and as such, this will be the point of departure henceforth.

In 1651, Jan van Riebeeck, an employee of the Dutch East India Company (VOC[105]) set off on a journey from the Netherlands to establish a permanent station at the Cape of Good Hope (Turton, 2009). The Cape station would serve as a refreshment station and "general rendezvous" for the large VOC fleets that would travel from Europe to the Far East (Ross, 2014). In addition to this, the station would be a means of "procuring vegetables, meat, water and other needful refreshments and by this means restore the health of the sick" (Ross, 2014: 243). Over the next century, the Europeans continued to settle in the Cape and began to fulfil a number of urban functions which meant that the Cape Colony began to develop into a modest town[106] (Ross, 2014). More specifically, Van Riebeeck began to establish a rudimentary judicial system, which largely remained unchanged until the end of the Dutch administration in 1795 (Fagan, 1996). Notwithstanding this, the Cape remained predominantly rural and agricultural and as such, there was very little need for insurance between 1662 and 1795 (MacGregor, 2012). It is therefore not surprising that during this time there existed no South African insurance market.

In July 1795, a British fleet under Admiral Keith Elphinstone and Major-General James Craig sailed into False Bay, a harbour which the VOC had failed to fortify (Worden, Van Heyningen & Bickford-Smith, 2004; Bray, 2008). Following failed negotiations, a regiment of Khoikhoi[107] soldiers were sent by the Dutch to carry out their masters' business (Bray, 2008). The latter is well known as the *Battle of Muizenberg.* Soon thereafter, the regiment retreated and the town subsequently surrendered (Bray, 2008). The British took control of the Cape Colony from 1795-1803 during the Napoleonic wars and after these wars, returning it to the Dutch (under the rule of the Dutch Batavian Government) for a brief period[108], finally conquered the Cape Colony and thereafter took permanent occupation in 1806 (Electoral Institute for Sustainable Democracy in Africa, 2011).

[105] The Dutch Acronym for *Vereenigde Oost-Indische Compagnie.*

[106] During this time the Khoikhoi embarked on "an unsuccessful series of armed resistance" against the Dutch invasion that would continue for one hundred and fifty years (South African History Online, n.d.).

[107] Also known as the "Khoe", the Khoikhoi occupied portions of Southern Africa, including what is now referred to as the Namib Desert, the Kalahari Desert and the Karoo (Turton, 2009).

[108] In terms of the treaty of Amiens.

British insurance companies soon began to follow the movements of British citizens to the Cape Colony and began to set up business (Spyrou, 1955; Verhoef, 2012). The first insurance agents in the Cape Colony were appointed by the *Phoenix Assurance Company of London* on the 6th of August 1806 (Verhoef, 2012). Thereafter, between 1826 and 1844, five British insurers entered the Colony (Verhoef, 2012). On the 14th March 1831, the first indigenous South African insurance company, the South African Fire and Life Assurance Company, was established by Mr Thomas le Breton (Vivian, 1996). Soon thereafter, in 1835 the *Zuid-Afrikaansche Brand en Levensversekering Maatschappij* was also founded in the Cape Colony (Verhoef, 2012).[109] Table 4 below provides a summary table of such developments.

In 1838, some thirty years after the British reclaimed the Cape, a large group of Afrikaans-speaking Boers, the majority of which were Dutch and French immigrants, left the Cape and founded their own Boer Republics in the Natal, Orange River Colony[110] and Transvaal provinces to eradicate the British control over themselves[111] (Johnson, 2004). However, this was short-lived. Following the discovery of diamonds and gold in 1867 and 1886 respectively, the influx of foreigners escalated and the British soon claimed administrative control of Natal (Johnson, 2004). By 1861 more than twenty insurance companies operated in the Cape and following the mineral discoveries in the late 1860s, the number of insurers operating in the Colony escalated dramatically (Verhoef, 2012). This appears to have been owing to the growing urban population and the high risks associated with the mining industry (Verhoef, 2012).

[109] Thereafter the South African Mutual Life Assurance Society (1845), the Equitable Marine (1849) , the Colonial Assurance Company (1874), the South African Mutual Life Assurance Company (1891), the Southern Life Association (1891), and the Industrial Life Assurance Company of South Africa (1894) were established.

[110] Today known as the Orange Free State and hereafter referred to as such.

[111] This movement is well known as the Groot Trek (The Great Migration) by the Voortrekkers.

Table 4: Summary of the early developments of the insurance industry in South Africa

Date	**Name of Insurance Company**
1806	Phoenix Assurance Company of London
1826	United Empire and Continental Life Assurance Association
1826	The Alliance British and Foreign Life and Fire Assurance Co
1831	South African Fire and Life Assurance Company
1835	Cape of Good Hope Fire Insurance Co
1835	Zuid-Afrikaansche Brand en Levensversekering Maatschappij
1838	The Cape of Good Hope Marine Insurance Company.
1844	Equitable Fire and Life Assurance Trust Co
1845	South African Mutual Life Assurance Society
1849	Equitable Marine
1853	Guardian Assurance and Trust Co. of Port Elizabeth
1856	Commercial Marine and Fire Assurance Co
1874	The Colonial Assurance Company
1891	The South African Mutual Life Assurance Company
1891	The Southern Life Association
1894	The Industrial Life Assurance Company of South Africa

The Voortrekkers once again attempted to assert their independence and two wars subsequently ensued (Verhoef, 2012). The first Anglo-Boer War[112] ended in 1881 with a resounding victory for the Afrikaners following the Battle of Majuba (Wilcox, 2007). The British refused to accept that they could simply be defeated by what were "essentially farmers and very much part-time soldiers" and accordingly, the second Anglo-Boer war was inevitable and took place between 1899 and 1902 (MacGregor, 2012: 141). The latter ended in victory for the British thereby "completing the long imperial conquest of Southern Africa" (Nasson, 2000: 149). This victory thus signalled Britain's domination of the sub region and was the catalyst for the integration of the Cape Colony, Natal, Orange Free State, and Transvaal into the Union of South Africa in 1910 (Verhoef, 2012). It was also during this time that British insurers began to dominate the fire insurance market (Verhoef, 2012).

[112] Also known as the South African War and/or the Boer War.

By early 1900s, the poor white problem[113] had long been recognised and the white Afrikaners began to engage in a process of upliftment. In particular, the Afrikaners, aware of their disadvantaged position, established the South African National Trust and Assurance Company Limited (Santam) in the May of 1918 (MacGregor, 2012; Benfield, 2013). A month later the Suid-Afrikaanse Nasionale Lewens Assuransie Maatskappy (Sanlam)[114] opened its doors with the specific purpose of "mobilizing Afrikaner savings to promote economic growth out of which they would be lifted out of poverty" (Verhoef, 2010; MacGregor, 2012:142).

Although the second Anglo-Boer war ended in a decisive victory for the British, numerically the English were always outnumbered by the Afrikaners (MacGregor, 2012). For that reason, following the 1948 general election, the popular vote placed the Afrikaners in the dominate position and the National Party (NP) won the ballot (Southall, 1994).[115] In 1961, the Union gained its independence and became known as the Republic of South Africa (Beck, 2014). By that time, the economy was expanding and so too was the insurance market.

8.2 Development of insurance law and regulation in South Africa

8.2.1 Roman Dutch and English Law

After colonisation by the British, the Roman Dutch common law which was brought by the Dutch settlers in 1652 was retained but over time was naturally influenced by English law (Fagan, 1996). More specifically, soon after 1806, British merchants complained about the Roman-Dutch procedures, the voluminous yet inaccessible body of Roman-Dutch insurance law, the inconvenience of the Dutch language and the incompetence of the local courts (van Niekerk, 1996). The British government in turn considered replacing the Roman-Dutch law with English law but instead opted to await the gradual infiltration of English law into the local legal system (van Niekerk, 1996:439).

[113] After roughly 150 years of European domination, the Europeans in South Africa had failed to build a sustainable economy. As a result of this, as the white Afrikaner farming population began to expand, the population exceeded the numbers which could be supported on the farms and poverty ensued. By the late 1880s and early 1900s the the poor white problem was at its worst (see Fourie, 2007; MacGregor, 2012).

[114] Now known as the English equivalent- the South African Life Assurance Company.

[115] The Afrikaner Nationalist Party remained in power until 1994 when the African National Congress (ANC) won the vote and became the ruling party.

Towards the latter half of the nineteenth century, the application of Roman Dutch law to insurance matters was being questioned. In particular, John Henry De Villiers (as cited in Van Niekerk, 1996:445), Chief Justice at the Cape from 1873 until 1910, commented that

> The enormous development of commerce in recent times requires a corresponding development of mercantile law, so that it becomes impossible *rigidly to apply* the rules obtained in Holland in the beginning of the present century to questions which arise out of customs of a later growth.

Accordingly, by 1878 there was a widespread acknowledgement that in many instances, Roman-Dutch law and English law could not always be reconciled and as such, there were calls for the abolition of Roman-Dutch law and its replacement with English law (Van Niekerk, 1996).[116] English insurance law was formally introduced into the Cape Colony in 1879 in terms of the General Law Amendment Act No. 8 of 1879.[117] The preamble to the 1879 Act wrote that

> The existing general law of the Colony is in several instances unsuited to the advancing trade and altered circumstances of the country… many portions of such law are uncertain, and partly, if not entirely obsolete… it is desirable to alter and amend such laws as are in conflict or inconsistent with modern principles of legislation.

The introduction of this Act established an important point with respect to insurance regulation; English insurance law and practice were being followed in South Africa. It is not unusual for countries to follow "best international practice". The important point is that the motivation for much of the insurance regulation is not founded in South Africa but in England even if justified or rationalised in South Africa. Following the annexation of the Orange Free State in May 1902, the Roman-Dutch common law continued to be applied in the colony (Millard, 2013). However, shortly thereafter, the General Law Amendment Ordinance 5 of 1902 was enacted which essentially mirrored the General Law Amendment Act which had been passed earlier in 1879 in the Cape Colony (Van Niekerk, 1996). English law was thus formally introduced into the Orange Free State at that time. Although English law was never formally introduced in Natal and the Transvaal, said courts nevertheless relied on English precedents and accordingly, English law principles infiltrated nationwide

[116] The case of Smith v. Davis (1878) 8 Buch 66 seems to have been the catalyst for this notion.

[117] The General Law Amendment Act of 1879 mainly concerned maritime and mercantile law (van Niekerk, 1996).

(Millard, 2013). The formal introduction of English law as the binding authority in the Cape and Orange Free State was not, however, beyond criticism.

In 1977, the General Law Amendment Act of 1879 and the General Law Amendment Ordinance of 1902 were "at last repealed" in terms of the Pre-Union Law Revision Act No. 43 of 1977 (van Niekerk, 1996). In terms of the 1977 Act, English law was no longer the binding authority in the Cape and Orange Free State. This meant that the application of the Roman-Dutch law of insurance was restored. As it stands today, albeit that English law is no longer the binding authority in South Africa, its principles are still adhered to in many parts of the nation (Ten Insurance Services Ltd, 2014). That is, English law is so well entrenched in South African precedent that although the courts are no longer inclined to follow old English law (but rather Roman-Dutch law) they are also not compelled to abandon precedent simply because it has English origins. As a result of this, the South African common law on insurance retains its international character (Kuschke, 2011).

8.2.2 Life Assurance Act No 13 of 1891

The first piece of insurance legislation to be enacted was the Life Assurance Act No 13 of 1891[118] passed by the eighth parliament of the Cape of Good Hope (Actuarial Society of South Africa, 2013). Up until this point, the law of insurance applied in the land was merely included in the general mercantile law at the time, with English Insurance Law being applied in cases which came before the courts in the Cape and Natal, whilst Roman Dutch Law was employed by the courts in the Orange Free State and the Transvaal (Benfield, 1997: 263). This Act aimed at "encouraging persons to insure" and at "protecting persons assured", and further called for an investigation into the financial conditions of a company by a qualified actuary every five years. As such, the financial condition of companies was to be investigated by a qualified actuary to ensure that the companies working practices were in order (Ten Insurance Services Ltd, 2014). Thereafter, said report was to be deposited with the Treasury in a prescribed format (Benfield, 1988).

Prior to the passing of the Act, Hansard (May, 1891 as cited in Benfield, 1997:264) reported that "the aim of the Bill [was] to compel companies to give proper statements to the

[118] In terms of the Companies Act No. 22 of 1892, the provisions of said Act did not apply to Insurance Companies where such provisions were inconsistent with the earlier 1891 Act (Scrutton, 1911).

Government of their business" and that "the Bill principally means further protection of policyholders". Between 1892-1908, a number of brief statutes were passed in the Cape Colony, Natal, Transvaal and Orange Free State (Benfield, 1988). More specifically, in all four provinces, the legislation that was passed generally required the payment of a deposit, the protection of both policies and the interests of policyholders and the making of financial disclosures (Benfield, 1997). This indicates regulation for consumer protections objectives.

8.2.3 Council of Fire Insurance Companies

As mentioned above, during the late 1800s and early 1900s, English insurance companies continued to dominate the insurance market in the Union, particularly with respect to fire insurance (Verhoef, 2012). As a result of this British influence, it is not surprising that the South African industry began to follow the British tariff system as discussed above. In 1894, the Cape Town Fire Tariff Committee was established and some years later, the Johannesburg Fire Tariff Association was formed (Borscheid, 2012). By 1898, tariff associations had been formed not only in Cape Town and Johannesburg, but also in Port Elizabeth, East London, Durban, Bloemfontein and Pretoria (Verheof, 2012). By the turn of the century, plans were put in place to establish a central body which would organise the countrywide fire insurance associations that had emerged throughout the 1800s (Vivian *et al*., 2016c). This was achieved by the Council of Fire Insurance Companies which was formed in 1907 and which was modelled on the UK FOC (Verhoef, 2015; Borscheid, 2012).[119]

It does not appear that any of the original documents concerning South African tariff committees or the Council have survived, except for possibly some records held by the Mutual and Federal Insurance Company (Vivian *et al*., 2016c). The loss of historical documents is unfortunate and accordingly, literature on the history of these bodies is thin. Notwithstanding this, it has been suggested that upon reflection, the Council appears to have played a somewhat consumer protection and market conduct regulatory role since the Council "promoted uniform and sound practices in fire business throughout the country, and contributed to the development of a sound market, good underwriting standards, sound insurance practices and procedures, and general engineering standards, modelled on the British associations" (Verhoef, 2012: 327).

[119] The South African Insurance Association, as it stands today has its roots in the Council of Fire Insurance Companies which was formed in 1907 (South African Insurance Association, 2013).

Soon after the tariff system was disbanded in the UK in the 1970s, the South Africa industry followed suit. This, however, created several problems in the South African market. In particular, the demise of the tariff system introduced price competition with which the South African market was unacquainted. By the late 1980s, there was growing concern with regards to the stability of the market owing to great unease since a number of companies' solvency ratios were perceived to be substandard (Vivian *et al*., 2016c). It was anticipated that because of this, there may be a market meltdown (Vivian *et al*., 2016c). The then registrar of insurance therefore called on insurers to find solutions in order to instil discipline in the market (Vivian *et al*., 2016c). This was done in terms of the market accord whereby insurers, with the consent of the registrar, agreed that they would not quote against one another unless their quote would be considerably less than the prevailing price (Vivian *et al*., 2016c). In fact, this would only be allowed if the competing insurance company was able to offer a 10 per cent reduction in premiums (Vivian, 2016). Insurers thereby began to operate successfully without the tariff.

In addition to this, following the demise of the tariff, model policy wordings no longer existed. Over time, insurers were increasingly being called upon by brokers to approve specific policy wordings which became particularly tedious and time consuming (Vivian *et al*., 2016c). In addition to this, it was almost impossible to compare benefit packages between policies, since policy wordings were vastly different (Randmark40, n.d.). The inconsistences of policy wordings also had an impact on reinsurance capacity (Randmark40, n.d.). In response to these problems, the insurance market suggested the establishment of a working committee (consisting of both brokers and insurers) who would collectively agree on a model policy wording (Vivian *et al*., 2016c). This culminated in the creation of the MultiMark series of policy wordings, the first of which was produced in 1987 (Randmark40, n.d). These MultiMark policies appeared to have been strikingly similar to the tariff model wordings which had preceded its birth (Vivian *et al*., 2016c). As it stands today, the MultiMark series of policy wordings have been abandoned for fear that they may have been anti-competitive and thus infringe on the Competition Act of 1998 (Vivian, 2007).

8.2.4 Insurance Act No 37 of 1923

During the first half of the twentieth century, a vibrant insurance market began to develop in the Union and insurance regulation began to emerge (Verhoef, 2012). The Insurance Act No

37 of 1923 was the first example of this, and accordingly, was the first piece of insurance legislation passed by the parliament of the Union of South Africa. The Act was passed some 13 years post Union and for that reason, it was argued that either there was "no great urgency" in the making of insurance legislation or that the provincial laws prior to the unionisation had been adequate (Benfield, 1988). However this was not the case. In fact, upon examination of various parliamentary debates, it was noted by the Minister at the time that such a piece of legislation had been worked on for several years prior to the formation of the Union (i.e. over the last twenty years) and specific reference is made to the British Assurance Act of 1906.

The 1923 Act undertook to "consolidate and amend the laws in force in several provinces in the Union relating to insurance". The South African regulatory system therefore pursued the Churchill legacy by having one regulatory system for one market. The Act further sought to create the role of Chief Office and Principal Officer in the Union and further stipulated that no insurance company (more specifically no life office) may transact business in the Union unless it was registered, licenced and had made the necessary deposit[120] in accordance with the provisions of the Act. Moreover, the Act concerned itself primarily with registration and licencing provisions in addition to setting out the form, method and extent of the various disclosure requirements (Benfield, 1997). In fact, it has been cited that the 1923 Act had enshrined the principle of "freedom with publicity", a principle which had been derived from the 1909 UK Assurance Companies Act[121] as discussed above (Benfield, 1997). In terms of this approach, insurers were granted wide discretion and a freedom to conduct their affairs without prescription provided that all activities and financial results were fully disclosed and available for public inspection (Benfield, 1988). In addition to this, the 1923 Act endeavoured to protect policyholders in the case of an insurer's insolvency.

8.2.5 Insurance Act No 27 of 1943

Throughout the 1930s, Professor Arndt criticized the 1923 Act for its numerous inadequacies and shortfalls. In particular, Arndt (1934: 274) commented that

> [The 1923] Act contains many loopholes which can be of the greatest value to promoters and vendors, at the expense of the innocent public. According to the

[120] A deposit of £25 000 was to be deposited with the Treasury.

[121] The 1923 Act therefore followed the British System in terms of the 1909 Act.

> Act, the Registrar of Companies would appear to be no more than a routine registering robot, who has no discretion or can pass no judgment on what he registers as long as the documents formally comply with the letter of the law… The powers to exercise his [Registrar of Companies] discretion and to pass judgment, within prescribed limits, should go a long way towards protecting many innocent but inexperienced small savers and investors who are at present paying unnecessarily heavily for their inexperience.

Arndt (1934:279) further expressed that

> Insurance companies are the small man's savings institutions... the small man [has to] entrust the management of his savings to others who, in the interest of the community as a whole and in view of their trustee function, should be required by the State to observe certain minimum standards… More constructive legislation regarding the investments and their distribution would therefore seem to be imperative.

As such, Arndt questioned the "control and supervision" of financial institutions[122] and thereafter called for direct requirements relating to the investment policies of insurers, since according to his argument, too great a discretion posed an unreasonably high risk to policyholders (Benfield, 1997; Verhoef, 2012). The Insurance Act No 27 of 1943 was therefore subsequently passed, largely on the basis of Arndt's criticisms and recommendations (Benfield, 1997).

The 1943 Act governed the conduct of insurance business in the Union and accordingly set out the regulatory framework within which insurers conducted their business (le Roux, Penfold & Webber Wentzel Bowens, 1998). The 1943 Act introduced a number of direct statutory prescriptions in terms of which a number of provisions were stipulated. These included:

- The registration of insurers
- The appointment of a Registrar of Insurance (under the control of the Minister of Finance) for the administration, supervision and control of the insurance industry
- The manner in which business ought to be conducted by Lloyd's underwriters operating in the South African market

[122] Arndt (1934) had further argued that the depository amounts prescribed by the 1923 Act did not bear any relationship to the volume of business conducted. In other words, he argued that the deposits made to the Treasury were of no consequence whatsoever and afforded no conceivable protection to the policyholders.

- The appointment of an auditor and a valuator
- The respective duties of both the auditor and the valuator
- The submission of returns to the Registrar of Insurance
- The holding of assets (specifically what fixed proportions of assets were to be held in prescribed securities known as statutory designated investments i.e. compulsory investments in Government bonds) and what proportion was discretionary)

Once again, in retrospect, it appears that the 1943 Act sought to protect the public from unauthorised conduct and in doing so, was an early form of consumer protection regulation.

The 1943 Act further provided for the first time, the appointment of a Registrar of Insurance to whom appeals under the Act would be made (Benfield, 2013:89). George Beak, an actuary, would become the first Registrar of Insurance and soon established the Financial Institutions Office (FIO) which sat in Pretoria (Benfield, 2013). The day-to-day administration of the Act was performed by the then newly created FIO (Benfield, 1997).

8.2.6 Commission of enquiries

The statutory regulation of the insurance industry remained unchanged in principle until 1973[123] when the Franszen Commission issued the *Report of the Commission of Enquiry into Fiscal and Monetary Policy* (Verhoef, 2012:336). In terms of the report, the Commission advised that no foreign controlled company with more than a 10 per cent shareholding in foreign stocks should operate in the South African insurance market. Said recommendation was duly transposed into the South African legislative framework by virtue of the Companies Act No 76 of 1974 in terms of which insurers had to both register and comply with the statutory requirements for "locally incorporated companies" (Verhoef, 2012:338). It was during this time and particularly between 1965 and 1980, that the financial services sector was heavily regulated (Botha & Makina, 2011).

[123] This appears to be South Africa's first independent regulatory steps since South Africa had become a Republic in 1961.

Deregulation of the financial sector only started to take place in the late 1980s following the appointment a Commission of Inquiry into the Monetary System and Monetary Policy in South Africa in 1987 (Botha & Makina, 2011). The Commission, eventually known as the De Kock Commission, noted that institutional regulation, specifically in the banking sector, had resulted in over-regulation and a number of inefficiencies (Botha & Makina, 2011). The Banking Act No 94 of 1990 was passed soon thereafter to provide for the regulation and supervision of public companies taking deposits from the public. The 1990 Act further applied to any registered insurer (as defined in section 1 of the Insurance Act of 1943) who accepted a premium in respect of any policy. It was at this time that the South African regulatory structure, by virtue of the Banking Act of 1990, began to coordinate its legislation with international criteria and principles. That is, prior to the 1980s, South Africa's regulatory landscape "sluggishly" followed international trends and developments owing to its apartheid policies and political isolation (Botha & Makina, 2011:32). The 1990 Banking Act was therefore South Africa's first attempt to harmonise its regulatory framework with international best standards.

For roughly half a century, the governing legislation of the insurance industry remained the Insurance Act of 1943 which, as mentioned earlier, created the role of a statutory regulator-the Registrar of Insurance (Benfield & Vivian, 2003). However, toward the end of the 20th century, the South African insurance market was dealing with the aftershock of the collapse of the AA Mutual Insurance[124] which prompted the government of the day to appoint a Commission of Inquiry to investigate the reasons for its failure[125] (Vivian & Hutcheson, 2015). The Commission (1988) noted that the collapse of the AA Mutual could not be ascribed to a single cause but rather to a multitude of factors, some of which were interrelated. Among other things, the Commission (1988) suggested that a shortage of capital[126], the lack of correct technical reserving, bad management and lack of control, bad

[124] The AA Mutual carried out business in both life and short-term insurance.

[125] The Commission of Inquiry (the Melamet Commission I) under the chairmanship of Mr Justice D.A. Melamet, was appointed in 1987 and released its report 'The Report of the Commission of Inquiry into the winding-up of the short-term Insurance Business of the AA Mutual Insurance Association Ltd' in 1988.

[126] It has been argued that in fact "the liquidation of the AA Mutual was inappropriate" since in reality the AA Mutual was always solvent by having a substantial surplus. In fact, decades after the AA Mutual was wound up, there remained a substantial amount of cash in the bank (See Vivian, 2006a).

underwriting, the absence of currency matching for overseas liabilities and inadequate accounting, collectively culminated in the AA Mutual's demise.

At the same time, criticisms were levelled against the FIO[127] and its then Registrar, Robert Burton, since there was a large backlog in the checking of insurers' returns (Insurance Times and Investments, 1988). In particular, the Commission (1988) noted that the 1980, 1981, 1984 and 1985 returns submitted by the AA Mutual had not been checked, despite a number of warning signs preceding its "collapse". The Commission (1988) did however suggest that the FIO may have been overworked and understaffed and as such, could not perform all its duties. The latter sentiments were echoed countless times as van Staden[128] (1980 as cited in Insurance Times and Investments, 1990) pointed out that

> …the staff position of this Office [had] deteriorated to a point where it [was] no longer possible for the Office to perform effectively all the functions that [were] required of it by the [1943] Act. The stage [had] now been reached where not even the most basic of functions, such as the examination of the financial statements and actuarial valuation reports submitted by insurers [could] be attended to properly.

In its report, tabled in Parliament early in the July of 1988, the Commission not only presented its conclusions as to why the AA Mutual collapsed, but further recommended a number of stricter financial controls for the industry as a whole.[129] As a consequence of this, the regulatory landscape was reorganised, the supervisory legislation was modified and a voluntary ombudsman was appointed (Vivian, 2003:289). That is, in August 1989 the first short-term ombudsman was voluntarily appointed by the industry to "provide consumers with a free, efficient and fair dispute resolution mechanism"[130] (Vivian, 2003). Although the office proved to be a success, today it is regulated in terms of the Financial Services Ombud Schemes Act No 37 of 2004 so as to be in line with the Pension Funds Adjudicator, a statutory body which was established in terms of the Pension Funds Act No. 24 of 1956.

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[127] The forerunner of today's Financial Services Board (FSB).

[128] A previous Registrar of Insurance until 1983.

[129] Amongst other things, the Commission suggested the introduction of a policy holders' protection board or the establishment of a guarantee fund in addition to the introduction of an ombudsman to deal with queries and complaints.

[130] Prior to this, a disgruntled consumer had to resort to an expensive and protracted litigation process to resolve a dispute with an insurer.

8.2.7 Current regulatory landscape in South Africa

As mentioned earlier, soon after South Africa's political seclusion ended in the mid-1990s, the country's regulatory system quickly got accustomed to international standards. For this reason, the Melamet Commission recommended in 1993 that South Africa adopt a unified regulatory system that would be in line with European developments and in particular, one which would mirror the UK's now defunct FSA (Botha & Makina, 2011). However the Commission's recommendations were not accepted and instead a functional approach, with three different regulators for the financial market, was preferred and accordingly, each regulator continued to regulate its respective industry. As a result of this, currently, the South African regulatory and supervisory system consists of a number of different regulators who are coordinated through both statutory and the now repealed advisory standing committees[131] (Botha & Makina, 2011:32). In particular and at present, three main regulatory bodies regulate the South African financial services market. These include the Financial Services Board (FSB), the South African Reserve Bank and the Council for Medical Schemes.[132] Within the insurance context, the FSB is responsible for the regulation of both the short term and long term insurance industry.

The legislative reforms in South Africa did not cease as the newly elected African National Congress (ANC) government began to find its feet and in doing so conducted an extensive review of the legislation affecting financial markets (Vivian, 2003:289). This movement was further reinforced as the FSB embarked on an wide-spread new legislative programme which saw i) the passing of both the Long-term Insurance Act 52 of 1998 and the Short-term Insurance Act 53 of 1998[133] (including subsequent amendments to these Acts), ii) the enactment of the Financial Advisory and Intermediary Services (FAIS) Act 37 of 2002[134],

[131] Although the regulatory authorities were at one time contemplating the adoption of a unified and integrated regulatory system, the global financial crisis exposed a number of weaknesses characteristic of this approach and thereby reaffirmed South Africa's earlier decision not to adopt an integrated regulatory system (See Botha & Makina, 2011).

[132] The banking industry is regulated by the South African Reserve Bank, the regulatory oversight of medical schemes are conducted by the Registrar of Medical Schemes, under the auspices of the Department of Health, and remaining financial markets are regulated by the FSB.

[133] Both the Long-term and Short-term Insurance Acts replaced the Insurance Act of 1943.

[134] Furthermore, various Financial Institutions Amendment Acts, the Financial Intelligence Centre Act (FICA) No 38 of 2001, and the Collective Investment Schemes Control Act 45 of 2002 were also passed.

and iii) the promulgation of Policyholder Protection Rules and Clawback of Commissions Regulations mainly for the long insurance markets (Benfield & Vivian, 2003: 277). These legislation and regulatory instruments support the broader regulation of the insurance market since such industry laws have all endeavoured to serve to better protect financial customers and to strengthen regulatory action. These developments resulted in significant market restructuring, market share changes and regulatory co-operation (Benfield & Vivian, 2003). A discussion of the current regulatory landscape in South Africa follows.

8.2.8 Financial Services Board (FSB)

Soon after the Melamet Report was published, the Financial Services Board Act No. 97 of 1990 was passed which culminated in the establishment of the Financial Services Board (FSB).[135] It is imperative to note at this point however, that despite the overarching consensus that the FSB was promulgated following the Melamet Commission Report (1988) and its recommendations, upon careful examination, a different view may be argued. In terms of the report, albeit that the Commission (1998) was concerned over the need for a "properly and adequately staffed" financial institutions board, the report merely discussed and did not recommend the idea of a new financial services regulator. More specifically, the Commission (1988: 120-123) pointed out that

> In England, Germany and Switzerland, the short-term insurance industry contributes financially to the upkeep of the regulatory office… It is [however] clear from the attitude of the various short-term insurers in South Africa that they would not wish to make financial contributions to the upkeep of the regulatory office if they had no say in and control over how such moneys were expended…Such a financial contribution does not appear, to the Commission, to be an acceptable solution to the problems of the Office of the Registrar. The solution would appear to be the creation of an independent body under the control of the Minister of Finance, in which both the Central Government and the private sector play an active role, and which is financed by contributions from both the State and the private sector… What the Commission recommends, for consideration by the responsible Ministers, is the creation of a national council or board for financial institutions…If regard is had to the billions of rands controlled by the various financial institutions, the need for such a body drawing on the best available brains in the Government service and the private sector is obvious…If the above recommendation finds favour with the authorities, it will obviously be necessary for a further commission or a working group of experts to work out and consider the detail and

[135] The FSB came into operation on the 1st April 1991 under the chairmanship of Mr Justice David Melamet who too stood as chairman of the Melamet Commission in 1988.

> ramifications of such an organisation. The above comments are born of a sense of urgency regarding the need to obtain adequate and qualified staff for the Office of the Registrar… This would allow for proper policing of the industry, and reduce the possibility of a recurrence of the collapse of a short-term insurer.

As such, the Melamet Commission recommended only that a commission or working group be appointed to consider the creation of a national council or board for financial institutions and thus did not itself recommend the actual creation of the FSB. It was in fact the Van der Horst Committee (chaired by Dr JG van der Horst) that advocated the establishment of an independent institution or "Statutory Board" to supervise and regulate the non-banking financial services industry (FSB, 2010). As such, the Melamet Commission may have planted the proverbial seed, but it was the Van der Horst report which ran with the idea and ultimately made the recommendation upon which the FSB was soon thereafter established (Michaels, 2005).

As mentioned above, the 1990 Financial Services Board Act sought to provide for the establishment of a board to i) supervise the compliance of the non-banking financial services industry with laws regulating financial institutions; ii) advise the Minister of Finance on matters concerning financial institutions and financial services and; iii) promote programmes and initiatives to inform and educate users and potential users of financial products and services. All financial institutions which were formally supervised by the FIO would now be supervised by the FSB- an umbrella body for the supervision of insurance companies, pension funds and other financial markets (Benfield, 2013).[136] As such, the original 1990 Act had in mind that the FSB would become the main supervisory body of financial institutions and an advisory committee to the Minister of Finance on all matters concerning financial institutions.[137]

The FSB supervises and performs its functions not only through its various departments but also in terms of 16 Parliamentary Acts (Rossouw, van der Watt & Malan, 2002). These Acts entrust numerous regulatory functions to various registrars including the Registrar of Long-

[136] For all intents and purposes, the FSB performs the ex FIO's functions although with just 12 members of staff, the former FIO does not measure up to the size, power and scope of the FSB today (Sandrock, 2014).

[137] Today the FSB is an institutional body with a net worth over R800 million- something that the original FSB Act of 1990 arguably never had in mind.

and Short-term Insurance, Friendly Societies, Pension Funds, Collective Investment Schemes and Capital Markets, all of which are accountable to the FSB's Executive Officer.

The construct of South African legislation often mandates a government functionary body to vary the application of the respective Act by means of a plethora of subordinate regulation (Sandrock, 2014). It is at this point that an understanding of subordinate legislation and its limits is important. The necessary point of departure is therefore the Magna Carta.

In the early 13th century, a number of government officials were accused of persuing their own interests through legislative devices which lead to an abuse of the system and the potential for dictatorship (Vivian & van Vuuren, 2016). This is a well-known phenomenon. Lord Acton in 1906 pointed out that "this law of the modern world, that power tends to expand indefinitely, and will transcend all barriers, abroad and at home, until met by superior forces, produces the rhythmic movement of history". Accordingly, if there is a system that allows individuals to enrich themselves through state power, they will do so (Vivian, 2015e).

King John attempted to do the very latter. In particular, in 1215, King John required that wealthy landowners and barons pay "scutage" or money in lieu of military service (Whitton, 2009). This was essentially a form of arbitrary tax (Vivian & van Vuuren, 2016). The barons however pointed out to the King that he could levy no taxes without their consent (Vivian & van Vuuren, 2016). Nonetheless, the barons agreed to pay the taxes provided that the King would grant them a number of special concessions (Vivian & van Vuuren, 2016). Specifically, the barons gathered outside London in the June of 1215 and demanded that the King sign a charter (Whitton, 2009). In 1215, King John therefore assented to the Magna Carta which endeavoured to ensure that officials were under some control and therefore could not dictate laws without limitation (Vivian & van Vuuren, 2016). In particular, officials were under the control of an assembly of barons and would have no legislative powers beyond this assembly. In terms of this approach, the King's authority became bound by what the assembled barons agreed (Vivian & van Vuuren, 2016). Over time this became known as the King's Council which with the passing of time was referred to as Parliament (UK Parliament, nd.).

Accordingly, laws began to develop from parliament; the laws were what the assembled barons, the King, his nobles and later on, the commons, agreed to. As such, over time Parliament was recognised as the "sovereign legislative institution" (Vivian & van Vuuren,

2016). Today this can be referred to as constitutional democracy in terms of which only elected law makers have the authority to make laws that uphold constitutional norms and values (Vivian & van Vuuren, 2016).

As will be discussed, a number of Acts of Parliament have begun to contain provisions which enable a minister or some other delegated authority to make regulations. These regulations can be referred to as subordinate legislation. The delegation of powers ought to be limited, since if not, parliament is authorising the government to make its own laws and constitutional democracy will be replaced with dictatorship (Vivian & van Vuuren, 2016). This is the very thing that the Magna Carta outlawed over 800 years ago. The very distinction between a dictatorship and constitutional democracy will be lost. A legislative representative therefore should have no power to delegate his power to another. However the latter appears to be exactly the case today.

The Financial Services Board Act of 1990 is one such example, since it has far-reaching powers to decide on a wide scope of matters with little to no consultation with interested parties (Sandrock, 2014). For example, the FSB has gained sweeping powers through this structure which amongst other things has allowed them to determine their own remuneration.

According to Section 11 of the original and un-amended Financial Services Board Act of 1990

> A member or an alternate member of the board or a member of any committee of the board who is not in the full-time employment of the State shall be paid such remuneration and allowances out of the funds of the board as the Minister may determine.

Furthermore, Section 14 provides that

> the board may pay to the persons in its employment, or provide them with, such remuneration, allowances, bonuses, subsidies, pension and other employment benefits as the board may, after having obtained such professional advice as it may deem fit, consider as being competitive in the open market for the manpower concerned.

As such, the original 1990 FSB Act had envisaged that the FSB would be paid by the state and not the private sector. A more significant development however transpired when the 1990 Act was later amended in terms of which the FSB is to be funded by virtue of a tax levy imposed on the financial services industry. More specifically, according to Section 15A(1) of

the Financial Services Board Act of 1990, "the board may impose by notice in the *Gazette* levies on financial institutions and may, subject to the provisions of this section, at any time in similar manner amend, substitute or withdraw any such notice".

As a result of this, "the FSB imposes a tax on financial institutions without consent, without Parliament [and] indeed without any safeguards at all" and as such, unelected bureaucrats are placing themselves on the private sector payroll wherein the above problem of constitutional democracy is being undermined (Vivian, 2015f:65). Simply put, regulators have high-jacked the legislative process in order to impose a tax on the private sector which is not moderated by parliament at all (Vivian, 2015a). This most certainly contravenes articles 12, 14 and 15 of the historic Magna Carta and in doing so, undermines South Africa's democratic organisation. In particular, the Magna Carta famously notes that no taxation ought to be imposed without consent (Vivian, 2015e). In other words, tax cannot be imposed on any individual unless Parliament explicitly agrees to it[138] (Vivian, 2015e).

Furthermore, since the FSB is financed by the financial services industry itself, with no contributions from the state, a number of the Melamet Commission's earlier submissions also appear to have been disregarded (Ennew & Waite, 2007). In particular, the Commission (1988) pointed out that a national council or board for financial institutions should be funded by both government and the private sector. Furthermore, the Commission (1988) had specifically noted that salaries paid to the regulatory office should not be borne by the private sector.

The FSB has thus been described as a unitary state within a state since it makes law, implements and administers said law, polices and enforces that same law, adjudicates disputes through various ombudsmen and tribunals and imposes penalties on the basis of this

[138] This matter recently gained attention in the case of *Shuttleworth v South African Reserve Bank and others* 2014 ZASCA 157. The SA Reserve Bank had imposed an "exit levy" on all funds leaving South Africa. As a consequence, Mr Shuttleworth was required to pay R250 million when he decided to take monies out of South Africa, which he did so under protest. Mr Shuttleworth subsequently took the matter to court and on appeal the Supreme Court of Appeal declared the "exit levy" to be an unlawful taxation. In particular, although the Magana Carta was not referenced, the SCA correctly noted that "a founding principle of Parliamentary democracy is that there should be no taxation without representation and that the executive branch of government should not itself be entitled to raise revenue but should rather be dependent on the taxing power of Parliament, which is democratically accountable to the country's tax-paying citizens."

adjudication (Louw, 2015; Vivian, 2015e; Vivian, 2015f). One entity therefore has gained a number of draconian powers as the executive, the legislature and the adjudicator and this renders Parliament and courts of law almost completely redundant. This is problematic and violates both the Magna Carta (articles 29, 38, 39 and 48) and the modern Constitutional system (in terms of the separation of powers). In fact, the FSB has often been accused of acting in a "one-sided and apparently arrogant manner" and in turn, said regulators have frequently been accused of undermining constitutional democracy (Sandrock, 2014). It therefore follows that the modern regulator is returning to the position which was outlawed 800 years ago and therefore violates the constitutional principle of separation of powers (Vivian, 2015e; Vivian, 2015f: 67). Furthermore, one can argue that such a regulatory agency is undermining the application of the Lockean framework.

8.2.9 Long Term Insurance Act

In January 1987, the long awaited Draft Bill "to consolidate and amend the law relating to long term insurance and to provide for matters incidental thereto" was published for comment (Benfield, 2013). The Bill contained "far-reaching divergences" from previous legislation and indeed, did not echo the deregulation policies synonymous with the government of the day (Benfield, 2013:98). In fact, a number of "surprising" and "novel" proposals were included in the Bill and as a result of these diversions, the Draft Bill was never given effect (Benfield, 2013). In particular, the 1987 draft Bill had empowered the Minister of Defence (Magnus Malan) to dictate the terms of insurance policies (Benfield, 2014). It was also at this time that regulators began to consider the Melamet Commission's (1988) report. In particular, the Melamet Commission had commented that

> The present Insurance Act [of 1943] and Regulations afford policy holders and the general public protection which is, possibly not as full as is desirable, but by appropriate amendments the position can be improved considerably… So far as South Africa is concerned an amalgamation of the proposed insurance legislation for life and short-term business should not cause the Act to be lengthened inordinately. It was contended in evidence that it would be a more scientific and legalistic approach to the problems of insurance if the organisational and functional aspects and the contracts of insurance aspects were dealt with separately in legislation. The Commission supports this contention… There should be one Act covering both life and short-term insurance dealing with the constitution, control and financial stability of insurers and a separate Insurance Contract Act dealing with that aspect of insurance.

Almost a decade after the first Draft Bill was circulated for comment and the Melamet Commission's recommendations were published, a revised Long Term Insurance Bill was submitted. The latter would eventually culminate in the passing of the Long-term Insurance Act 52 of 1998[139] to provide for the registration of long-term insurers; for the control of certain activities of long-term insurers and intermediaries; and for matters connected therewith.

Keeping in line with the objectives of this paper, part VII of the Act sets out a number of provisions that attempt to ensure policyholder protection and good business practice. More specifically, Sections 44-65 of the Act attempt to regulate both the conduct of long-term insurance business operations as well as their prudential affairs in order to safeguard policyholders. Most notably, section 45 states that "no person shall provide, or offer to provide, directly or indirectly, any valuable consideration as an inducement to a person to enter into, continue, vary or cancel a long-term policy". Furthermore, and consistent with the consumer protection objective, section 46 notes that a long-term insurer shall not enter into any particular kind of long-term policy unless the statutory actuary is satisfied that the premiums, benefits and other values thereof are actuarially sound.

Section 50(1) of the Act is considered to be "the most controversial provision" and has attracted widespread criticism (Benfield, 2013). According to this provision, the Registrar[140] may, after consultation with the Advisory Committee (which no longer operates today) and in concurrence with the Minister, declare a particular business practice to be undesirable. Said provision has been criticised as the Act provides no further definition of what constitutes "desirable" and accordingly, opens the way for possible abuses (Benfield, 2013). Section 62 of the Act further enables the Registrar to propose rules to ensure that policies are entered into, executed and enforced in accordance with sound insurance principles and practices and in the interests of the policyholders and in the public interest generally. The 1998 Act further encumbers the Registrar of long-term insurance business with other far-reaching "discretionary controls" and because of this, the Act is often described as "regulation by

[139] Later amended in terms of the Insurance Amendment Act No. 17 of 2003.

[140] According to section 2(2) of the LTIA, the executive officer of the FSB shall be the Registrar of all long-term insurance business.

inclination" (Benfield, 2013). Examples of the latter are contained in, amongst others, section 9(2)(a), section 10, section 15 and section 22(1). The provisions contained therein are fleshed out as per table 5.

Section 9(2)(a) of the Act (which sets out the various conditions for the "application for registration") provides that the Registrar may grant an application to carry on long-term insurance business on such of the conditions as the Registrar may determine. Accordingly, the Registrar is given extensive regulatory discretion to impose any such additional conditions as he may personally see fit. Furthermore, the conditions of registration as contemplated in section 10 of the Act are all to be "determined by the Registrar" and further provide that "different conditions may be determined [by the Registrar] in respect of different long-term insurers". According to Section 15(3), the Registrar may impose a prohibition or determine a limitation and a condition on an insurer if it is in the interests of the policyholders of a particular long-term insurer or the long-term insurance industry as a whole to do so. Once again, the Registrar, at his inclination, is granted extensive powers to stretch the conditions imposed on insurers without any legislative constraint or definitive criteria.

Moreover, Section 22(1) provides that the Registrar may require a long-term insurer to terminate the appointment of a director, managing executive, public officer, auditor or statutory actuary of that long-term insurer, if the person or firm concerned is not fit and proper to hold the office concerned. However, the Act provides no objective guidelines as to how such a determination is to be made and accordingly, the Registrar has extensive power to determine who is "fit and proper" to hold office.

Table 5: Overview of Part VII (business practice, policies and policyholder protection) of the Long-Term Insurance Act

Section Title	***Sections***	***Section***	***Section Content***
Business practice	44-50	44	Free choice in certain circumstances
		45	Prohibition on inducements
		46	Policy to be actuarially sound
		47	Receipt for premium paid in cash, and validity of policy
		48	
		49	Summary, inspection and copy of policy
		50	Limitation on remuneration to intermediaries
			Undesirable business practice
Policies	51-61	51	Policy suspended until payment of first premium
		52	Failure to pay premiums
		53	Option for payment of policy benefits in money
		54	Limitation on provisions of certain policies
		55	Limitation on policy benefits in event of death of unborn or of certain minors
		56	Voidness of certain provisions of agreements relating to long-term policies
		57	Life policy in relation to person rendering or liable to render military service
		58	Long-term policies entered into by certain minors
		59	Misrepresentation and failure to disclose material information
		60	
		61	Validity of contracts
			Prescription of certain debt
Policyholder protection	62-65	62	Protection of policyholders
		63	Protection of policy benefits under certain long-term policies
		64	
		65	Option for realisation of protected policies
			Partial realisation of protected policies

8.2.10 Short Term Insurance Act

At the same time as the Long-term Insurance Act was passed, the Short term Insurance Act No 53 of 1998 was enacted which took effect on the 1st of January 1999 and replaced the 1943 Insurance Act in its entirety[141]. Although the Melamet Commission (1988) had remarked that the 1943 Insurance Act and Regulations achieved little consumer protection and that two separate Acts covering both life and short-term insurance separately would be desirable, it appears as if regulators had forgotten about the debate which was had in 1993. Furthermore, regulators overlooked Churchill's legacy in terms of which the insurance market as a whole should be regulated by a single piece of legislation. Recall that the Burnard scandal in the UK in 1902 was the catalyst for a single and holistic system for the entire insurance market, and this saw the passing of the 1909 British Assurance Act. Accordingly, regulators most likely forgot about the debate about one piece of legislation versus two pieces of legislation and so two Acts were passed simply because it is thought to be a "jolly good idea".

The Short-term Insurance Act of 1998 endeavours to provide for the registration of short-term insurers; for the control of certain activities of short-term insurers and intermediaries; and for other matters connected therewith. As such, the basic objective of the Short-term Insurance Act is to avoid abusive business practices and to ensure that insurers conduct their business on sound financial lines so that policyholders can confidently rely upon their stability (Visser, Pretorius, Sharrock & Van Jaarsveld, 2003: 487).

The preamble to both the Long-Term and Short-term Insurance Acts are almost identical, however the distinction between long-term insurance and short-term insurance is embodied in section 1(1) of each respective act, really for administrative purposes only (Visser *et al.*, 2003). In fact, prior to the passing of both the Long-Term and Short-Term Insurance Acts, the Melamet Commission had noted that

> From a cursory examination of both the draft Acts the Commission gained the impression that these are divergent only to a 20 % extent, 80 % of the wording

[141] It has been cited that the South African legislature did not adequately engage with history before passing two separate pieces of Insurance legislation. Prior to the Bernard scandal in the UK, the British parliament had also passed separate insurance legislation. Following the scandal, Cuthbert Heath of Lloyd's noted that once piece of insurance legislation should exist for the industry as a whole. British Prime Minister at the time and son-in-law to Heath duly acted and the 1909 Act was subsequently passed.

> and provisions being identical. It appears to the Commission that there is little purpose in having two separate Acts.

In addition to this, *each* Act requires the appointment of a Registrar of insurance, which according to Benfield and Vivian (2003:276), implies that two separate registrars for the short-term industry and the long-term industry should be appointed respectively. However, in terms of Section 2(1) and (2) of the Short-term Act, the executive officer and a deputy executive officer of the FSB shall be the Registrar and the Deputy Registrar of Short-term Insurance, respectively. Similarly, according to Section 2(1) and (2) of the Long-term Insurance Act, the Registrar of insurance shall be the executive officer of the FSB, while the deputy executive officer of the FSB shall be Registrar of Long-term Insurance. Accordingly, the CEO of the FSB is in each case the Registrar. Notwithstanding this, South Africa moved away from one piece of insurance legislation and instead, two separate acts were passed, one dealing with the long-term insurance industry and the other covering short-term insurance business.[142] Although there is considerable duplication between the two Acts, the most significant provisions of the Short-term Insurance Act, to the extent that they relate to policyholder protection and conduct of business, are briefly discussed (and appear in table 6) so as to avoid redundancy.

Similar to Sections 44-65 of the Long-Term Insurance Act, part VII of the Short-Term Insurance Act stipulates a number of provisions relating to an insurer's business practices, the issuing of policies and policyholder protection. Section 44 of the Act provides that no person shall provide, or offer to provide, directly or indirectly, any valuable consideration as an inducement to a person to enter into, continue, vary or cancel a short-term policy. As such, inducements are specifically prohibited by the 1998 Act in order to ensure that only products which are most suitable for a prospective policyholder are recommended and maintained. Section 49 of the Short-term Act further prohibits any undesirable business practices, and like Section 50(1) of the Long-term Act stipulates that the Registrar may, after the necessary consultation and due process declare a particular business practice to be undesirable. Once again however, no clear definition of "undesirable business practices" is given and accordingly, such a determination is quite subjective. Policyholder protection is specifically addressed in Section 55 of the Short-term Act. In terms of this provision, the Registrar may,

[142] At present, South Africa appears to be harmonising insurance legislation within the sector. The Insurance Bill is currently in its second draft.

after proper consultation, propose, vary or revoke rules that aim to ensure that policies are entered into, executed and enforced in accordance with sound insurance principles and public interest.

Table 6: Overview of Part VII (business practice, policies and policyholder protection) of the Short-Term Insurance Act

Section Title	***Sections***	***Section***	***Section Content***
Business practice	43-48A	43 44 45 46 47 48 48A 49… …	Free choice in certain circumstances Prohibition on inducements Collection of Premiums by Intermediaries Receipt for premium paid in cash, and validity of policy Copy of policy and inspection of policy records Independent intermediaries remuneration Binder agreements
Policies	50-54	50 51 52 53 54	Limitation on policy benefits in event of death of unborn or of certain minors Voidness of certain provisions of agreements relating to short-term policies Short-term policies entered into by certain minors Misrepresentation and failure to disclose material information Validity of contracts
Policyholder protection	55	55	Protection of policyholders

“Regulation by inclination” prevails in the Short-term Insurance Act, since once again, the Registrar of insurance is granted a number of discretionary powers. Such flexibility can be found in Section 3, Section 4, Section 11, Section 12, Section 34, Section 49, Section 55, Section 62 and Section 63 of the Short-Term Insurance Act.

8.2.11 Policyholder Protection Rules

In terms of the aforementioned Long and Short-term Insurance Acts, a number of policyholder protection rules were also introduced in 2001 to ensure that consumers are provided with sufficient and relevant information to make informed choices and in doing so, provide a certain amount of consumer protection. According to Part II of the Short Term Insurance Act, the objective of these rules is to ensure that policies are entered into, executed and enforced in accordance with sound insurance principles so that they are practiced in the interests of consumers and the public in general. Accordingly, such rules apply to ensure that the parties involved conduct business fairly and with due care and diligence.

According to Part III of the Policyholder Protection Rules, a direct marketer must, amongst other things:

- render services honestly, fairly, and with due skill, care and diligence;
- act honourably, professionally and with due regard to the convenience of the policyholder;
- make representations that are factually correct, provided in plain language, and are not misleading;
- disclose to the policyholder the existence of any circumstance which gives rise to an actual or potential conflict of interest and take all reasonable steps to ensure fair treatment of the policyholder; and
- disclose commissions, considerations, fees, charges or brokerages that may be payable to the direct marketer (if any) by the policyholder or by any other person.

In summary, the salient features of the above rules, are therefore to ensure i) that consumers have all relevant information in order to make informed decisions and ii) that insurers and intermediaries act honestly and fairly, with due care and diligence. The Policyholder Protection Rules are accordingly designed to ensure professional market conduct and are largely reinforced by a system of disclosure (Charter Life, n.d).

8.2.12 Financial Advisory and Intermediary Services (FAIS) Act of 2002

As mentioned earlier, in 1993, the Ministry of Finance began investigating various mechanisms for regulating the business conduct of the financial sector (The Banking Association South Africa, 2016). Accordingly, there was greater attention on enhanced consumer protection and market conduct regulation. At this time, there was also a greater awareness that no formal system existed to regulate financial advisors and intermediaries and that products were sold purely for high commission purposes with little regard to the needs and wants of the consumer (FAIS Credits and Training, 2012). The latter was therefore the impetus for the Financial Advisory and Intermediary Services (FAIS) Bill which eventually culminated in the passing of the Financial Advisory and Intermediary Services (FAIS) Act of 2002 to protect consumers of financial products and services.[143]

In view of that, the Act regulates the rendering of certain financial advisory and intermediary services to clients. Most surprisingly, however, is that the Act also regulates the activities of the actual financial service providers themselves. Accordingly, the financial service industry is regulated by its own industry laws in addition to the FAIS Act. The main purpose of the Act is to protect consumers of financial products and services by i) regulating the selling and advice-giving activities of financial services providers; ii) ensuring that the consumers are provided with adequate information about the financial product they use and about the people and institutions who sell these financial products in a competent and open manner; and iii) establishing a properly regulated financial services profession (Financial Services Board, n.d.).

In order to achieve this, the FAIS Act has introduced a principle-based approach to regulating the market conduct of Financial Service Providers (FSP) and intermediaries (National Treasury, 2014a). This approach has been supported by various rules and Codes of Conduct pertaining to the rendering of advice and/or intermediary services. In particular, the Act requires that all FSPs are licenced by the FSB, all representatives of all authorised service providers are adequately qualified and that financial services are at all times rendered with due skill, care and diligence and are in the interests of clients (The Banking Association South Africa, 2016). This is further reinforced by Codes of Conduct which set out minimum

[143] After a recommendation by the Nel Commission, the Financial Advisory and Intermediary Services Act of 2002 became effective on 15 November 2002.

disclosure requirements, conflict of interest management requirements, requirements around needs analysis and advice and requirements pertaining to record taking (National Treasury, 2014a:83).

In particular, although not an exhaustive list, the General Code of Conduct for Authorised Financial Services Providers and Representatives[144] requires that a provider:

- render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry;
- act honourably, professionally and with due regard to the convenience of the client;
- make representations and provide information to a client that is i) factually correct, ii) in plain language, iii) avoids uncertainty or confusion, and iv) is not misleading;
- disclose to the client the existence of any personal interest, or any circumstance which may give rise to an actual or potential conflict of interest in relation to such service, and take all reasonable steps to ensure fair treatment of the client;
- take reasonable steps to seek from the client appropriate and available information regarding the client's financial situation, financial product experience and objectives to enable the provider to provide the client with appropriate advice;
- identify the financial product or products that will be appropriate to the client's risk profile and financial needs; and
- provide a reasonable and appropriate general explanation of the nature and material terms of the relevant contract or transaction to a client, and generally make full and frank disclosure of any information that would reasonably be expected to enable the client to make an informed decision.

The FAIS Act alone could not itself guarantee adequate consumer protection and accordingly, the Financial Services Ombud Schemes Act of 2004 was subsequently passed which provided for the establishment of a FAIS Ombud. Aggrieved clients historically had

[144] The General Code of Conduct for Authorised Financial Services Providers and Representatives was published under Board Notice 80 of 2003.

very little recourse against dishonest advisors and those who felt that they have received poor advice had to seek remedy through the formal, costly and often time consuming formal court system (FAIS Credits and Training, 2012). The FAIS Ombud therefore plays an integral part in the broader consumer protection objectives by resolving consumer disputes relating to the rendering of financial services in an efficient and affordable manner[145] (Financial Services Board, n.d.). Furthermore, consumers may also seek redress if they have been unprofessionally or recklessly treated by a financial advisor or provider (National Treasury, 2014a). In terms of the Financial Ombud Schemes Act, the FAIS Ombud has the power to act as the Statutory Ombud and can adjudicate a complaint through mediation or conciliation, can issue a binding determination and may order the payment of monetary awards, damages and costs (Financial Services Board, 2010).

The FAIS legislation, its various regulations and Codes of Conduct have all had a strong emphasis on consumer protection by ensuring that individuals who give advice in a professional capacity are subject to various rules. Despite these endeavours however, the FAIS regulatory framework has attracted widespread criticism as concerns remain about poor customer outcomes, since it has been argued that practices of inappropriate advice and product mis-selling continue (National Treasury, 2014a: 54). As part of the broader customer protection objectives, the FSB has therefore undertaken the Retail Distribution Review (RDR) to be discussed in section 8.3.4.

8.2.13 Enquiry on Consumer Credit Insurance in South Africa (Nienaber Enquiry)

In 2007, a Panel of Enquiry was established to investigate the alleged abuses in the Consumer Credit Insurance (CCI) market (National Treasury, 2014b). In particular, this followed media allegations that some insurers, active in the CCI market, were persistently contravening commission regulations and paying commissions in excess of the permissible maximum rates (Report by the Panel of Enquiry on Consumer Credit Insurance in South Africa, 2008). Since CCI could be written on either a short term or long term basis, the Life Offices' Association (representing long-term insurers) and the South African Insurance Association (representing short term insurers) together coordinated an investigation to "identify and eradicate undesirable practices prevalent in the consumer credit insurance market impacting negatively on consumers" (Joint Media Release of the LOA and SAIA, 2008).

[145] The FAIS Ombud deals only with disputes having arisen after 1 October 2004.

The Panel of Enquiry on Consumer Credit Insurance in South Africa (hereon referred to as the Nienaber Panel) was tasked with reviewing the CCI market structure, assessing the existing policy and regulatory framework for the sector and proposing recommendations to reform the policy framework in order to regulate the CCI industry more effectively (National Treasury, 2014b). The panel was therefore mandated to undertake an investigation to identify and eradicate undesirable practices prevalent in the CCI market that potentially impacted negatively on consumers. In doing so, the panel made a number of findings and recommendations in terms of its Report (2008). These findings and recommendations are set out below.

In terms of market conduct issues, the panel concluded that although there are various and adequate market conduct legislative requirements in place, this does not necessarily ensure that said requirements are complied with by industry players. More specifically, the panel identified the STIA of 1998, the LTIA of 1998, the FAIS Act of 2000, the FAIS General Code of Conduct, various Policyholder Protection Rules and in particular, the National Credit Act 35 of 2005, as all having provisions which endeavour to regulate market conduct risks. Although these provisions exist, and although the panel acknowledged that insurers try to comply with these provisions, the panel pointed out that in practice, compliance is not always guaranteed. As such, poor market conduct practices remain.

The panel noted that among these poor market practices was i) the lack of proper disclosure, ii) the pre-sale mis-selling by intermediaries, iii) the lack of awareness by consumers that they have in fact signed up for CCI, iv) the fact that CCI policies are often forced upon consumers, v) the failure of intermediaries to explain the limitations and exclusions of cover and vi) the potential conflicts of interest that may exist in the market. As a result of this, the panel recommended proper disclosure structures be affected in order to allow consumers to make informed decisions and which should be properly monitored and enforced to ensure compliance. The panel noted that although the Life Offices' Association and the South African Insurance Association should establish a composite and permanent standing subcommittee to deal specifically with CCI, the National Credit Regulator would be better placed and best suited to enforce such market conduct regulation.

Regarding intermediary remuneration, the panel concluded that the provisions contained in the STIA of 1998 and in the LTIA of 1998 which relate to intermediary remuneration were

particularly complex and unclear. In particular, the panel noted that a CCI policy could be issued by an insurer under either a long-term or a short-term licence. This resulted in a discrepancy since the LTIA of 1998 regulates the intermediary remuneration specifically in the case of a credit scheme whereas the STIA of 1998 has no corresponding provision. Furthermore, the general rates payable under the STIA of 1998 are different to the rates payable under the LTIA. The disparate commission structures set out in the two Acts had thus resulted in confusion and various anomalies which had caused a "commission arbitrage". The panel therefore recommended that the provisions of both Acts, insofar as they relate to intermediary remuneration, should be reviewed and revised in order to ensure clarity.

Of particular significance however, was the panel's view on the regulation of commissions paid by an insurer to an intermediary for procuring business. The latter is also known as an introduction fee. The panel's view on this point was far less clear as panel members were divided on the issue. On the one hand, various panel members advocated deregulation of the introduction fee in its entirety. The basis upon which this view was advocated was that market forces will ultimately determine the level of the premiums and the amount of remuneration payable to intermediaries. Therefore, any commission regulation would be anti-competitive.

Contrary to this, advocates of commission regulation pointed out that the deregulation of commission payments would cause an increase in premiums, the cost of which is ultimately borne by consumers and accordingly, this would be to their detriment. As such, members of the panel who were in favour of maintaining a maximum cap on commissions, believed that it is the only effective means of "foiling a recognised mischief, namely, the payment by insurers to intermediaries of improper incentives". Since members of the panel had conflicting views, collectively the panel eventually conceded that the level at which commission payments ought to be capped, should be determined by various regulators in conjunction with both industry and intermediary representatives. The panel therefore noted that the issue of regulation or deregulation would be better determined by way of discussions between the industry and various regulators.

Subsequent to the panel's recommendations, a number of regulatory initiatives have ensued. The most notable regulatory response to the panel's recommendations has been the implementation of the Treating Customers Fairly (TCF) framework. In addition to this, and in

support of the TCF framework, the Retail Distribution Review (RDR) intends to review the intermediary services landscape in South Africa in order to promote appropriate, affordable and fair advice to policyholders (National Treasury, 2014b: 51). This project is also being supported by the "enhanced future market conduct regulation mandate of the FSB" in terms of the Twin Peaks regulatory model (National Treasury, 2014b: 51). A discussion of the aforementioned developments is set out in forthcoming sections.

8.2.14 Consumer Protection Act No 68 of 2008

Over the years, South Africa's regulatory framework for market conduct and consumer protection has been reinforced and strengthened by a number of consumer protection laws, one of which includes the Consumer Protection Act of 2008 (CPA) (National Treasury, 2011).[146] The CPA was enacted as it was thought that preceding consumer protection laws in South Africa were outdated, fragmented, and uncomprehensive and founded on principles that were contrary to the democratic system (Stoop, 2015:211). The Act therefore provides an overarching framework for consumer protection and sets out the minimum requirements to ensure adequate consumer protection in South Africa (The South African Institute of Chartered Accountants, 2015). Accordingly, where insurance services and instruments are excluded from the scope of the other insurance Acts, the CPA will apply first and foremost (Kuschke, 2011:770). Furthermore, where other sectoral laws relating to conduct of business and consumer protection apply, these will need to be read in conjunction with the CPA in order to ensure a consistent standard of consumer protection (The South African Institute of Chartered Accountants, 2015).

According to the Act, such consumer protection legislation is necessary to:

- promote a fair, accessible and sustainable marketplace for consumer products and services;
- promote and protect the economic interests of consumers;
- establish national norms and standards relating to consumer protection

[146] Various other consumer protection laws have also strengthened consumer protection regulation in South Africa. These include the Financial Services Ombuds Schemes Act of 2004, the National Credit Act of 2005 and the Financial Markets Act No 19 of 2012 (FMA).

- provide for improved standards of consumer information so that consumers are able to 'make informed choices according to their individual wishes and needs';
- prohibit certain unfair marketing and business practices;
- promote responsible consumer behaviour; and
- develop effective means of redress for consumers.

The Act attempts to achieve the aforementioned objectives by providing a legal framework to i) maintain a fair and efficient marketplace for consumers; ii) promote fair business practices and; iii) protect consumers against unconscionable, unfair, unreasonable, improper and unjust trade practices and against fraudulent, misleading, deceptive and unfair conduct (Van Huyssteen, Van der Merwe, Maxwell, 2010: 117). The Act provides such a framework in terms of various sections that specifically identify various consumer rights. In particular, the Act emphasises that the most important consumer rights are: the right to equality, the right to choose, the right to privacy, the right to disclosure and information, the right to fair and responsible marketing, the right to fair and honest dealing, the right to fair, just and reasosnale terms and condisions and the right to fair value, good quality and safety. By ensuring that each of these rights is not violated, adequate consumer protection will be achieved.

8.3 Current regulatory developments in South Africa

As mentioned earlier, the ideal regulatory philosophy is first to identify a specific market problem and then to import regulatory measures to address these issues. However, upon examination of the international market and specifically the South African insurance market, it has been argued that modern regulatory reform is falling short of this ideal. In other words, modern regulatory developments are no longer addressing specific market imperfections but rather are merely "rearranging the deck chairs on the Titanic" (Vivian, 2015a). That is, the regulatory environment is simply been reorganised and rearranged and further, no rules-based legislation is being implemented as a problem solving tool in response to a market failure or problem. What transpires rather is the creation of Centralised Bureaucratic Regulators (Vivian, 2015a). It has been argued that the National Treasury is seeking to "rearrange the deck chairs on the Titanic" as it calls for a greater regulatory oversight in response to

perceived, yet arguably unfounded, shortcomings in the regulatory structure pertaining to the insurance market. The journey to the Twin Peaks is evidence of this.

As noted earlier, "protecting customers and ensuring they are treated fairly by financial institutions is the essence of market conduct policy and law" (National Treasury, 2014a: 6). Government has gradually been taking steps to transform the regulatory structures that govern the financial sector so as to be in line with the objectives stated above. In particular, Government's appetite for greater market conduct regulatory oversight has been witnessed as it takes steps toward establishing a dedicated market conduct regulator (National Treasury, 2014a). This has been in response to both retail-banking problems and in an effort to follow global trends.

National Treasury (2014a) has presented parliament with a number of reasons as to why a more complex regulatory regime is needed for the financial sector in general. As already mentioned above but worth emphasising again, is the fact that this has not been in response to a specific insurance market event but rather in response to *perceived* malpractices in the market. Furthermore, the impetus for regulatory reform is largely owing to banking sector problems; not insurance industry problems.

National Treasury has presented a hypothetical case scenario (based on "Thandi") in order to justify the need for enhanced regulation of the insurance market. Although no real-world or practical examples have been presented, the National Treasury has alluded to a number of problems in the insurance market, some of which include: i) complex policy provisions, ii) misrepresentation of products and iii) the repudiation of valid claims by insurers (Vivian, 2015d). As such, the National Treasury (2014a) has indicated that consumer mistreatment is the basis for a tighter regulatory regime.

There is however, no evidence that the consumer experiences any mistreatment at the hands of insurers. The short-term industry can be referred to as an example. About 30 years ago the industry set up a voluntary ombudsman scheme to provide independent, inexpensive and efficient dispute resolution (Millard, 2014). In the event that any personal lines customer felt that their claim had been incorrectly dealt with, the claim could be referred to the ombudsman and the industry would abide by the decision of the ombudsman. The 2015 annual report of the Office of the Short term Ombudsman indicates that the industry had received 2 980 000 claims. Of these, 9119 were referred to the ombudsman. Expressed differently, 0.3 per cent

of the total claims received by the industry were referred to the ombudsman. Of the 9119, 2 487 received some benefit from the ombudsman. This translates to 0.08 per cent of claims. All cases where the ombudsman felt that the consumer should receive benefits were settled by the insurer. This has been the pattern since the ombudsman scheme was introduced. Thus it can be said that there is no known case where a consumer has been treated unfairly. The ombudsman system was designed in an attempt to prevent this from happening.[147]

Vivian (2015d) further argues that a number of mechanisms and institutions already exist in the market to address the problems noted above. These include the Plain Language Institute, the Advertising Standards Authority, the Financial Services Board's ombud and various other policyholder protection rules as discussed above. Accordingly, existing laws, regulations and regulatory agencies are equipped to deal with these potential issues. Nonetheless, although no insurance market event has specifically been identified, Government has maintained its call for enhanced regulation and has issued the National Treasury Policy Document[148] which sets out a number of proposals to strengthen the financial regulatory system (Botha, 2011).

Government has also maintained that a better customer experience in a financial market promotes a stronger financial sector which in turn, results in stronger economic participation and growth (National Treasury, 2011). Accordingly, a well regulated market that promotes consumer confidence in the market and thereby encourages consumer participation in the market is necessary to achieve broader economic objectives. Government has therefore endeavoured and continues to endeavour to strengthen market conduct regulation in the financial sector in general. In doing so Government has had a greater focus on implementing market conduct initiatives and programmes that minimise the potential for customer abuse.

Government's desire to establish a market conduct regulator has also been part of their attempts to implement the Twin Peaks model of regulation which is said to be formally implemented should the Financial Sector Regulation (FSR) Bill be assented to. Following the 1993 Melamet Commission, South Africa originally opted for a single regulator of the financial services sector. It made the same decision in the early 2000s when once again the idea of two different centralised regulators arose (National Treasury, 2011). However,

[147] The number of investment linked complaints received by the ombudsman may warrant the need for a more complex regulatory system; however it would be unsuitable to include the insurance market in such an assessment.
[148] Issued in February 2011.

following the global financial crisis however, there has been a global shift away from the single regulator approach towards the Twin Peak regulatory model, which South Africa also intends to adopt. The implementation of the Twin Peaks regulatory system provides regulators with an opportunity to "modernise" the current market conduct regulatory framework (Nation Treasury, 2014). Notwithstanding this, a greater emphasis on market conduct regulation has been on the Government's agenda long before its decision to implement the Twin Peaks system of regulation. These developments are set out below.

8.3.1 Competition Commission Banking Enquiry Panel (Jali Enquiry)

In 2008, the 'Jali Enquiry', appointed by the Competition Commission, investigated a range of public concerns including high bank charges, the market power of the four biggest banks, access to financial services, and whether banks had contravened the Competition Act (du Preez, 2014). The panel subsequently made 28 recommendations, falling into five categories; three of which specifically addressed market conduct issues (BusinessDay, 2012). In particular, the Banking Enquiry Report to the Competition Commissioner (2008: 6) highlighted the "poor treatment of customers in the retail-banking sector" [149] since "there was an absence of market conduct regulation throughout the banking industry". The Enquiry had thus identified a major gap in the market conduct regulatory regime of the retail banking sector which meant that banking customers were exposed to the risk of unfair treatment (du Preez, 2014). The National Treasury (2011) therefore strongly advocated the establishment of a dedicated banking services market conduct regulator within the FSB who would be responsible for regulating all market conduct issues pertaining to the retail banking sector. Accordingly, Government's appetite to transform the financial sector by establishing a dedicated market conduct regulator was first given impetus by the work of the Jali Enquiry. The journey continued therefrom.

[149] As mentioned before, it has been various problems in the banking and investment sector that has called for such regulatory reform and not insurance problems. Notwithstanding this, the regulatory developments taking place in South Africa are affecting the insurance industry in its entirety.

8.3.2 Treating Customers Fairly

In 2011 FSB began implementing its Treating Customers Fairly (TCF) approach to supervision after publishing the TCF Discussion Document in April 2010.[150] This was the FSB's endeavour to pursue a TCF programme similar to that which had been implemented in the UK (Financial Services Board, 2010).[151] The FSB (2011) noted that amongst other things, the asymmetry of information that exists between a retail financial services consumer and a financial institution often means that a consumer is vulnerable to unfair treatment. The FSB also argued that this problem is exacerbated by low levels of basic and financial literacy in South Africa which in turn, increases the risk of consumer exploitation (2011). Accordingly, the FSB pointed out that greater consumer protection was warranted.

The FSB's vision therefore was to create a market conduct framework that will ensure that customer needs are appropriately met through a sustainable industry by i) improving customer confidence in the market, ii) ensuring that appropriate products and services are supplied and, iii) enhancing transparency and discipline in the industry (2011: 7). The latter was to be achieved through the TCF approach.

The TCF programme is therefore a regulatory initiative in terms of which firms are required to consider their treatment of customers at all stages of the product life-cycle (Financial Services Board, 2011). This includes the design, marketing, advice, point-of-sale and after-sale stages of any product (Financial Services Board, 2011). The approach is to focus on the six outcomes that underpin the TCF programme:

- Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

[150] The FSA however first began studying the TCF programme in 2000, published its first paper on the TCF programme in 2001, and officially launched the programme in 2005 (FSB, 2010). It therefore follows, that the FSB had long eyed the UK's TCF programme.

[151] The FSB's Market Conduct Strategy (MCS) Unit is responsible for facilitating the implementation of market conduct regulatory and supervisory frameworks for the FSB including the TCF programme.

- Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

- Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.

- Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and what they have been led to expect.

- Outcome 6: Consumers do not face unreasonable post-sale barriers to changing product, switching provider, submitting a claim or making a complaint.

There has been no specific single "launch date" planned for TCF implementation. Instead, the FSB has adopted an incremental approach to applying the TCF framework (Financial Services Board, 2013). Furthermore, and as will be discussed below, there will be a specific inclusion of TCF principles into the potential future, new and over-arching legislation to be introduced with the adoption of the Twin Peaks regulatory model (Financial Services Board, 2013). Although existing legislative and regulatory frameworks already require the application of TCF principles (one such example being the FAIS Act of 2002)[152] the regulatory reform to come will see TCF principles explicitly appearing in legislation.

8.3.3 Twin Peaks

In February 2011, the National Treasury published a policy document entitled “A safer financial sector to serve South Africa better” in terms of which it proposed various mechanisms to strengthen the financial sector regulatory system. The National Treasury (2011) noted that inadequate financial sector regulation, or “light touch” regulation had resulted in the proliferation of products such as subprime mortgages which ultimately caused the crisis. As such, the National Treasury (2011) maintained that a system of self-regulation

[152] In particular, section 16(1)(b) of the 2002 Act states that financial services providers "must act with circumspection and treat clients fairly in a situation of conflicting interests". Further examples can be found in the Act where numerous provisions and requirements specifically provide for such outcomes. Accordingly, it can be argued that TCF principles are not new but rather have been applied for more than a decade following the passing of the FAIS Act in 2002. (See Millard & Maholo, 2016).

had lost credibility and that government was now forced to reconsider their approach to financial sector regulation.

The policy document further highlighted the various market conduct malpractices which may have contributed to the crisis and went further to emphasise the role of market conduct regulation in complementing prudential regulation objectives. National Treasury (2011) thus proposed a number of improvements which seek to strengthen both the market conduct and prudential regulation of the financial regulatory system in South Africa. These reforms are guided by the following principles:

- Principle 1: Financial service providers must be appropriately licenced or regulated.
- Principle 2: There should be a transparent approach to regulation and supervision.
- Principle 3: The quality of supervision must be sufficiently intense, intrusive and effective.
- Principle 4: Policy and legislation are set by government and the legislature, providing the operational framework for regulators.
- Principle 5a: Regulators must operate objectively with integrity and be operationally independent, but must also be accountable for their actions and performance.
- Principle 5b: Governance arrangements for regulators and standard-setters must be reviewed, so that boards perform only governance functions.
- Principle 6: Regulations should be of universal applicability and comprehensive in scope in order to reduce regulatory arbitrage.
- Principle 7: The legislative framework should allow for a lead regulator for every financial institution that is regulated by a multiple set of financial regulators.
- Principle 8: Relevant ministers must ensure that the legislation they administer promotes coordination and reduces the scope for arbitrage.

- Principle 9: The regulatory framework must include responsibility for macro prudential supervision.

- Principle 10: Special mechanisms are needed to deal with systemically important financial institutions (SIFIs).

- Principle 11: Market conduct oversight must be sufficiently strong to complement prudential regulation, particularly in the banking sector.

- Principle 12: Financial integrity oversight should be effective to promote confidence in the system.

- Principle 13: Regulators should be appropriately funded to enable them to function effectively.

- Principle 14: Financial regulators require emergency-type powers to deal with a systemic financial crisis, requiring strong and overriding legislative powers.

- Principle 15: All the above principles are reflected in international standards like Basel III and standards set by the International Association of Industry Supervisors (IAIS) and International Organisation of Securities Commission (IOSCO). To the extent that there are any contradictions or inconsistencies in the above principles, the international standards will apply.

Given the policy's priority to strengthen both prudential and market conduct regulation[153], South Africa is moving toward the Twin Peaks regulatory model which recognises that financial soundness and TCF objectives are better achieved by two separate regulators

[153] This appears to be somewhat counter-intuitive since the very same policy document acknowledges that the South African financial sector did not experience significant financial upheaval as a result of strong policies. Although South Africa has sound macroeconomic fundamentals, National Treasury (2011) notes that over one million jobs were lost in South Africa and as such, government has a renewed focus on maintaining financial stability, strengthening consumer protection and ensuring that financial services are appropriate, accessible and affordable. Furthermore, National Treasury (2011) maintained that prior to the financial crisis, regulatory reform was already on the agenda because of the existence of a number of "market failures" in the financial services sector. National Treasury (2011) maintained that these market failures stemmed largely from the presence of asymmetric information between consumers and firms.

(National Treasury, 2014a). This transition will therefore most likely see the passing of the FSR Bill (to become the Financial Sector Regulation Act) which will create the Financial Sector Conduct Authority (FSCA) as the new market conduct regulator and the Prudential Authority (PA)[154] (within the South African Reserve Bank) which will take on the role of macro prudential regulator (National Treasury, 2014a). The FSCA will therefore become the dedicated regulator for market conduct in the financial services sector to ensure that good customer outcomes are delivered[155] (National Treasury, 2014a). It therefore follows that the current FSB will be dissolved and replaced with the FSCA.

The FSR Bill provides "extensive, flexible, and where necessary intrusive powers" to the FSCA and sets out various objectives for the FSCA (National Treasury, 2014a:25). These objectives include:

- Fair treatment of financial customers
- Efficiency and integrity of the financial system
- Financial literacy and capability

The FSR Bill further provides that the FSCA may set conduct standards for firms in order to promote the objectives stated above and these standards are to be consolidated into a single and comprehensive handbook (National Treasury, 2014a). The latter is similar to that which has been published in the UK. The TCF approach, as discussed above, continues to support government's market conduct strategies and accordingly will remain an important foundation for the new FSCA (National Treasury, 2014a).

The implementation of the Twin Peaks model and the subsequent strengthening of market conduct policy frameworks will most likely see a reform of the South African financial

[154] The PA will be responsible for ensuring that a firm has sufficient capital to meet future obligations (claims).

[155] The FSCA will need to work closely with other consumer protection watchdogs to ensure that market conduct problems are identified quickly and that necessary interventions are implemented timeously. Such bodies include the relevant ombuds, the National Credit Regulator, the Competition Commission and the National Consumer Commission. Furthermore, regulatory coordination between the SARB and the FSCA will be achieved through two committees including the *Financial Stability Oversight Committee* which will coordinate financial stability issues and the *Council of Financial Regulators* which will coordinate market conduct regulatory efforts.

services legal landscape. This includes revising and consolidating various regulatory and supervisory components. That is, a key feature of the reform is a proposed Conduct of Financial Institutions (CoFI) Act which will potentially consolidate all existing sector laws on conduct of business into a single piece of legislation (National Treasury, 2014a). More specifically, current market conduct laws and provisions[156] will be repealed and replaced with an overarching piece of conduct legislation.[157]

Such reform will come at a cost and the cost of such regulation will most likely be borne by the consumers of the product and not by the taxpayer (Vivian, 2015b). In fact, Vivian, MacGregor and van Vuuren (2016d) note that the Twin Peak system will cost the public approximately R6 billion per annum. The question then arises as to whether or not the public will derive any benefit from this cost; is this legislation in the public interest? A Socio-Economic Impact Assessment (SEIA) of the Bill notes that the system will produce "a stable and more inclusive financial sector" (National Treasury, 2016: 2). The need for stability specifically refers to the 2008 world banking crisis, as noted above (National Treasury, 2016). To begin with, the banking crisis, as the name suggests, refers to a banking problem and not an insurance one. It therefore follows that the system will produce no benefit to the insurance industry since the existing system has produced a stable short term insurance market already (Vivian *et al.*, 2016d). Furthermore, and as discussed above, no evidence exists which suggests that the short term insurance market is not treating its customers fairly. One can therefore argue that consumers will not benefit from a more stringent market conduct watchdog.

In addition to this, the banking crisis originated in other countries and it therefore appears illogical to suggest that a South African system will prevent another, potential, overseas problem. The R6 billion per annum cost of the Twin Peaks system is thus a deadweight cost as insurance consumers will get little benefit for their contributions. On this basis, the justification for Twin Peaks does not appear to be in line with public interest theory, a principle which has received much acclaim following Stigler's (1971) seminal work, as

[156] These include, amongst others, the Long Term Insurance Act of 1998, the Short Term Insurance Act of 1998, the Pension Funds Act of 1956, the Friendly Societies Act of 1956 and the Financial Advisors and Intermediaries Act of 2002.

[157] However, it is anticipated that the National Credit Act will operate alongside this single piece of conduct legislation.

mentioned above. This regulatory development may therefore be better explained by capture theory or perhaps more appropriately, by the theory of public choice; bureaucrats and regulators appear to be demanding this legislation and regulation for their own benefit.

In addition to the cost of such regulation, upon reflection on the impact results witnessed in various other countries, a number of other adverse outcomes may ensue as a result of tighter regulation. These may manifest in South Africa if the Twin Peaks model is adopted and include:

i) The destruction of innovation

ii) The creation of standardised products which are expensive

iii) The marginalisation and prejudice of consumers at lower ends of the market as a result of increasing costs

It appears that South Africa is aiming to fit the UK model of regulation into a framework with the different circumstances of a developing country which should rather encourage entrepreneurs and not stifle innovation (Cranston, 2015). Stifled innovation is always an unintended consequence of greater regulation (Cranston, 2015).

Winston Churchill said “the farther back you can look, the farther forward you are likely to see”. It appears however as if South Africa may be ignoring the historical developments that have taken place internationally, specifically within the UK. In particular, the South African regulatory system intends to place the prudential regulation of the entire financial market under the auspices of the SARB when the very same system failed in the UK. Market conduct and prudential regulation should therefore operate together, since both regulatory systems are not mutually exclusive (Vivian, 2015c). Legislatively, this appears to work better than a complex and fragmented system. The latter is supported by the fact that between 1906 (when the Life Assurance Act was passed) and 1986 (when the Financial Services Act was passed), the insurance market was holistically regulated which worked particularly well. This also conforms to Nobel Laureate Jan Tinbergen’s philosophy that one policy should be implemented in terms of one instrument and thus the two regulatory peaks should not be separated (Vivian, 2015c). South Africa should therefore maintain Churchill’s legacy of a

single, integrated and holistic system for each industry, as it has done since 1923. The history books bear testament to the success of such a system.

It is anticipated that the draft legislation and market conduct policy framework will be submitted to Cabinet for approval and tabling to Parliament in 2016 with possible implementation to follow in 2017 (National Treasury, 2014a).

8.3.4 Retail Distribution Review

Although the FAIS Act has introduced a number of provisions to improve intermediary professionalism and disclosure requirements, concerns remain as it is alleged that practices of mis-selling and inappropriate advice continue (National Treasury, 2014a). In particular, the FSB has noted that it still has significant concerns that customers are being sold inappropriate products that do not meet their needs and that there is a large degree of sales bias since some intermediaries are tied to a specific provider (KPMG, 2015). More specifically, it has been cited that where an intermediary provides advice to policyholders but is paid a commission by the insurer, this may affect the financial advisor's incentives to act independently and in the interests of the prospective client (National Treasury, 2011). Furthermore, the practice of "churning" by intermediaries has been identified by the FSB as a particular concern that warrants further reform.[158] As a result of this, the FSB has undertaken the Retail Distribution Review (RDR) which forms part of the broader TCF objectives as detailed above.

It has also been suggested that the FSB has eyed out this distribution model review in order to follow international developments and as such, concerns regarding market conduct issues arising from distribution and advice in the financial services sector are not unique to South Africa (Financial Services Board, 2014). South Africa has specifically ogled a number of developments that have taken place in the UK. It is therefore not surprising that such a review is underway since the UK undertook its own distribution review back in 2012.

In November 2014, the FSB published a discussion document which proposed a number of reforms to the current regulatory framework. In fact, a total of 55 proposals were released to be rolled out in three phases and which would endeavour to support fair customer outcomes

[158] Churning refers to the practice whereby financial advisors advise consumers with existing insurance cover to change insurance company (often to the detriment of the consumer) in order to earn a new commission all over again.

(Financial Services Board, 2015). The sheer numbers of proposals have attracted widespread commentary and criticism and one can describe the vast number of proposals as being unworkable and lacking in focus. A discussion of each proposal is superfluous to this research report, however the proposals are centred on three core issues, including: i) the types of services provided by intermediaries, ii) the relationships between product suppliers and intermediaries and the sharing of responsibilities between the two, and iii) intermediary remuneration models. Table 7 elaborates on the three core issues identified above.

The RDR and the potential regulations to flow from it therefore aim to improve the ways in which products are sold, the manner in which advice is given to consumers and the means through which intermediaries are remunerated in order to ensure that products are distributed in ways that support TCF outcomes (National Treasury, 2014a:54).

Table 7: Summary of the RDR proposals

Proposals relating to the types of services provided by intermediaries	Services provided by an intermediary include: • Financial planning • Upfront product advice • Ongoing product advice • Sales execution • Ongoing maintenance and servicing of product (post sales servicing) • Premium collection • Referrals	Proposals A-J
Proposals relating to the relationships between product suppliers and intermediaries	A customer should understand in what capacity the intermediary is acting, in order to evaluate the advice given and what potential incentives the intermediary may have to provide such advice. An intermediary providing such advice or financial planning may only do so in one of the following three capacities: • Independent financial adviser ('IFA') • Multi-tied financial adviser • Tied financial adviser	Proposals K-GG
Proposals relating to intermediary remuneration	The remuneration of intermediaries should, amongst others, meet the following criteria: • Should not contribute to conflicts of interest • Should be reasonable and commensurate with the actual services rendered • Cannot be paid twice for same service • Must be motivated, disclosed and explicitly agreed to by customer, and should be readily comparable	Proposals HH-CCC

In particular, the RDR seeks to ensure that distribution models (Financial Services Board, 2014):

- Support the delivery of suitable products and provide fair access to suitable advice for financial customers;

- Enable customers to understand and compare the nature, value and cost of advice and other services intermediaries provide;

- Enhance standards of professionalism in financial advice and intermediary services to build consumer confidence and trust;

- Enable customers and distributors to benefit from fair competition for quality advice and intermediary services, at a price more closely aligned with the nature and quality of the service, and;

- Support sustainable business models for financial advice that enables adviser businesses to viably deliver fair customer outcomes over the long term.

One of the most significant developments to flow from the RDR is the potential banning of commission payments to intermediaries. As discussed above, the FSB has cited the potential conflicts of interest inherent in the current commission model as the impetus for reform. It was noted in the FSB's discussion document (2014) that the tripartite legal relationship between the insurer, the intermediary and the prospective client is vulnerable to potential conflicts of interest. In particular, the temptation to provide biased product advice, if the intermediary is offered better remuneration by one product supplier or in respect of one product type rather than another, means that the commission led bias can undermine the quality of the advice offered (Financial Services Board, 2014: 21).

In order to avoid these potential conflicts of interest in terms of the advice rendered, the RDR proposes that the remuneration that an intermediary receives for providing advice should not be influenced by the product supplier. As a consequence of this, intermediaries should not receive a commission from the insurer but should rather receive a fee that has been agreed between the intermediary and the prospective client (Financial Services Board, 2015). Intermediaries should therefore remain "product neutral" and advise only those products that

meet the needs of the consumer irrespective of the product supplier-intermediary relationship (Financial Services Board, 2014).

It has also been suggested that the banning of commission payments may address the mis-selling of products where commission payments are based on a percentage of the premium payable. In particular, it has been argued that such commission structures create perverse incentives for intermediaries to recommend products with the highest premiums or with unrealistic premium escalations (Financial Services Board, 2014). The commission payable therefrom is often not commensurate with the actual cost of the service provided by the intermediary and in many cases, is proportionally too high. The banning of commission payments therefore ensures that suitable advice is provided at a price that is more closely aligned with the nature and quality of the service provided (Financial Services Board, 2014).

As mentioned above, the implementation of RDR proposals is set to take place in three staggered phases. To begin with, the implementation of 'phase 1 proposals' was envisioned to take place between the close of the period for comment on the RDR (March 2015) and the effective date of the FSR Act (Financial Services Board, 2015). The effective date of the FSR Act was anticipated to take place in late 2015 as Cabinet approved the Bill in November 2015 (National Treasury and Financial Services Board, 2016). However this timing has shifted as a revised version of the FSR Bill was tabled in Parliament in October 2015 (National Treasury, 2015). The Bill is expected to be passed in late 2016 with the aforementioned RDR proposals being implemented around this time (Financial Services Board, 2015). Notwithstanding this, it will be interesting to await the potential effects (if any) that the UK's Financial Advice Market Review (FAMR) will have on South Africa's implementation of RDR proposals.

As noted above, the UK's FAMR may see radical reforms to regulation which may roll back key aspects of the current RDR regulations in order to boost access to advice (Selby & Sands, 2016). This has been in response to a number of issues that have affected the distribution landscape following the implementation of such RDR regulations. In particular, broker numbers fell following RDR implementation which subsequently resulted in the advice gap (HM Treasury, 2015). The question therefore remains; in South Africa's determination to pursue international trends, will it learn anything from the adverse developments and impact results that have ensued thereafter?

8.4 Conclusion

The South African insurance market developed throughout the 1800s, during which time a number of insurance statutes were passed. The first of these statutes was the 1891 Life Assurance Act (Cape), which was a copy of the UK Act. This was not surprising since UK insurers dominated the SA insurance market and practice. This Act, like many others which followed it, was essentially prudential regulation concerned with various audit, financial reporting, deposit and financial disclosure requirements all having a prudential regulation flavour. Prudential regulation continued to develop in South Africa largely to keep abreast with international developments and standards of best practice. Thus the current SAM proposals are based on Europe's Solvency II. Very little motivation or justification comes from within South Africa, other than to follow overseas practice.

Historically and particularly during the early stages of regulation, the approach adopted was to identify a specific market problem and then to apply remedial measures directed at the problem. These by nature were prudential. In particular, following the collapse of the AA Mutual and the so-called inefficiencies of the FIO, a number of administrative changes were introduced. This eventually culminated in the passing of the FSB Act of 1990 and the creation of the FSB, a substantial administrative change. Unlike the UK, usually followed by South Africa, intermediaries were not regulated. By the 1990s, it was decided to regulate financial advisors and intermediaries in particular, and advice in general. At the time, the justification for this legislation was the high lapse rate of life insurance products. The latter was the catalyst for the 2002 FAIS Act which, for the first time in South Africa, signified the development of market conduct regulation. However as indicated above, market conduct regulation had been implemented in the US from the early 1900s and in the UK possibly from the passing of the Financial Service Act of 1986 but clearly became well entrenched with the passing of the FSMA 2000. The FSA morphed into the FCA in the UK. In placing more focus on market conduct, South Africa is once again doing what it has always done- it is following the UK and international practice. The origin of market conduct in South Africa is thus the desire to follow overseas practice.

This approach however loses sight of the historical approach to regulation; a response to known problems. In the short-term market, for example, the existing systems have ensured that there are virtually no known incidents of consumers being treated unfairly. Recent legislation is no longer directed at a specific and identified problem and this has resulted in

no clear idea as to how the new legislation will solve the problem which has not been correctly identified in the first place. The proposed introduction of the Twin Peaks regulatory system in 2011 is an example of this. No clear market problem has been identified as the catalyst for this reform. South Africa is simply following the UK which has dismantled its single peak model to introduce the earlier rejected Twin Peaks model. Instead of actual problems, regulators have attempted to justify the new and expensive R6 billion system on a number of fictitious scenarios to illustrate the importance of the new system. One may therefore argue that much of the legislations and regulations to follow may not necessarily be in the public interest. This may indicate the application of regulatory capture as a justification for such regulations. Notwithstanding this, the Twin Peaks system will most likely be implemented, and likely will see substantial changes to the South African regulatory landscape.

Insofar as market conduct regulation in South Africa is concerned, it can be concluded that it is of fairly recent origin. Furthermore, its origins have been the result of the desire to emulate predominantly UK regulatory developments.

9 CONCLUSION

The objective of the study was to establish the origins, development and nature of market conduct regulation. To achieve this objective, four insurance markets were examined. In doing so, the study posed the following research questions: i) when did market conduct regulation originate? ii) how has market conduct regulation developed over time? iii) does public interest theory apply to regulatory developments that have taken place during a particular period? iv) does the theory of regulatory capture apply to regulatory developments that have taken place during a particular period? v) what is the nature of the market conduct regulatory developments? i.e., to what extent did the Lockean framework (the due process of the law and the law of contract) apply during these periods? The latter was done specifically with reference to sporadic regulatory developments from which broader conclusions were developed.

In order to address these research questions, to begin with, the research has traced the development of insurance regulation in four pre-selected markets in order to then distil and plot the development of market conduct regulation. This has been done since limited literature is available which discusses the details of market conduct regulation. It has been noted that although market conduct issues arose as early as the 16th and 17th centuries, market conduct regulation originated in the UK from 1986 onwards and continued to develop throughout the early 2000s. It was pointed out that the collapse of Barings Bank in 1995 highlighted the failures of the complex systems introduced by the 1986 Act, as a prudential regulatory system. Recall, the FSA regulatory body was ill-equipped to deal with the prudential regulatory aspects of the British bank failures, a task that had rested with the Bank of England for almost 300 years. As a result of this, the system created by 1986 Act was abandoned and a new single peak regulatory system was created; the centre piece of which was the FSA. The 2008 financial crisis demonstrated that the FSA, as a prudential regulator, was a failure. It had ignored the prudential regulation of banks and acquired a life of its own as it morphed into a market conduct regulator.

The research findings indicated that, historically, insurance regulatory reforms in the UK were initially driven by specific corporate failures or market events. The collapse of the Albert Life resulted in the passing of the 1870 Life Assurance Act, the collapse of both the Fire, Auto and Marine Insurance Company and the Vehicle & General spurred the 1973 Insurance Companies Act and the 1975 Policyholders Protection Act, and various other

scandals provided the impetus for further regulatory reform. Governmental intervention was thus reactive and so a regulatory philosophy emerged in terms of which regulatory measures were adopted in response to specific market problems. The UK's 1986 Financial Services Act did not follow this approach. It was not in response to any market event. The Act created a complex and unworkable regulatory and administrative system, something America had done decades before. Contemporary regulatory developments continue in this direction. With the collapse of Barings Bank, a new single peak system was introduced. Furthermore, following the 2008 world financial crisis the Twin Peaks system was introduced. Each crisis produced a new administrative system. The research has therefore argued that modern regulatory developments are simply "rearranging the deck chairs on the Titanic" since no specific market corrective action is specified. Presumably the view is that once the new regulatory system has been set up the corrective action will come from the new system.

In the UK market conduct has emerged out of this milieu; almost by default. The FSA morphed into a market conduct regulator, as prudential regulation of banks and other institutions was transferred to the Bank of England leaving the FSA, now renamed FMCA, to become a market conduct regulator.

The research has also traced the development of insurance regulation in the US in order to discover the origins of market conduct regulation in this market. It was noted that during the mid-1800s, there were calls for the development of consistent and homogenous regulatory systems since a number of insurers operated across state lines and were therefore subject to varying state demands and regulatory requirements. This eventually culminated in the establishment of the NIC in 1871, today is known as the NAIC, in order to achieve such nationwide harmonisation of insurance regulation. It was noted that the NAIC's Constitution made a clear reference to its market conduct regulatory objectives. In particular, the fair, just and equitable treatment of policyholders and claimants, as enshrined in the NAIC'S Constitution, indicates the commitment to market conduct regulation. On the basis of this finding, it can be argued that the US predates the UK when it comes to market conduct regulation. Although traces of market conduct regulation can be found at earlier periods in the UK, the conscience drive toward achieving market conduct regulatory goals is more evident in the US at an early stage.

In tracing the development of South African insurance regulation, it was noted that the 2002 FAIS Act which regulated financial advisors and intermediaries, signified for the first time

the development of market conduct regulation in the South African market. Following this development, South Africa has largely followed international best practices and more specifically has been guided largely by UK regulatory steps. The origin of market conduct in South Africa, therefore, has been underpinned by the desire to follow overseas practice.

The question arises as to why have these regulatory developments taken place. To answer this question, this study draws on the economic theory of regulation, especially the theory of regulatory capture. In particular, the research argues that various regulatory developments have been driven by parties who have an interest in the regulatory process. Regulators themselves have an interest in the system.

There is very little evidence that market conduct regulation is in the public interest, a reason usually given for introducing regulation. In the short-term market in South Africa for example, 0.08 per cent of consumers benefit from the ombudsman system, a figure which is far too low to result in consumer demand for improved regulation. This is not a new phenomenon. In fact, evidence of regulatory capture can be found at various periods throughout the 16th and 17th centuries in the UK and further examples can be found thereafter. This research has referred to such examples to illustrate that regulatory capture is a more plausible theory to justify the "need" for regulation.

This research has also highlighted that historically, the market conduct relationship between the insurer and the insured was governed by the rule of law. This encompasses the law of contract and the due process of the law. These ideals were articulated by John Locke in the 17th century and therefore are referred to collectively as the Lockean framework. In terms of the Lockean framework, the obligations of both contracting parties are agreed to in terms of the contract and ought to be enforced by the courts in terms of the rule of *pacta sunt servanda.* Increasingly however, and particularly with reference to the UK financial market, market conduct regulators are imposing obligations that far exceed what was agreed to in contract. More specifically, expanding obligations are progressively being placed on insurance companies for equity purposes and consumer protection considerations. This can become particularly devastating since an insurance company cannot then be sure of its potential future liabilities. The near collapse of the Lloyd's market in the 1990s was referred to in order to demonstrate this problem.

Similarly the collapse of the Auction Alliance demonstrates how the modern market conduct regulator through various rules and regulations ignored the age old Lockean framework and the clear law of contract which has typically governed the relationship between consumers and service providers. Accordingly, modern consumer protection rules and regulations have confused clear and well entrenched common law practices. It therefore follows that when market conduct regulators impose obligations beyond what was agreed to in contract (or ignore the law of contract all together), the relationship between the insured and the insurer is no longer exclusively governed by the rule of law and the law of contract; the Lockean framework is no longer applied.

With reference to various, sporadic, UK market conduct regulatory developments, the research has demonstrated that throughout the almost 500 year history of the global insurance market, the Lockean framework was upheld and applied until 1986 when the first bureaucratic centralised managerial system was established, in the form of the FSA. Since this date and the birth of market conduct regulation coincide, it can then be argued that the market transitioned away from the Lockean system to a new system after this time. As such, contemporary market conduct regulation is not underpinned by the Lockean system but rather by a new system. If this is the case, the question arises as to what then is the framework that underpins the new system of market conduct regulation. It is not clear what the legal position is in modern times – it appears to be confusion.

As such, since this new framework is in its early form, the study has not attempted to define nor critique this framework although it has stressed that no other system should replace the law of contract when it comes to governing the interrelationship between two contracting parties. The former may nevertheless lend itself to further research. Furthermore, this research has not assessed the nature of all market conduct regulatory developments, which may be a further avenue for more focused future research. This may encompass an analysis of the impact and/or implications of market conduct regulation on insurance markets, an area that this study has not pursued.

In addition to this, the study was limited to only the four pre-selected markets, namely, the UK, EU, US and South Africa. This aspect of the study could be expanded in order to trace the origins and development of market conduct regulation in other countries. This will naturally provide a more comprehensive analysis. Similarly, the study focuses exclusively on the short-term insurance market in South Africa. Further research ought to be performed in

order to trace the development of the long-term (life assurance market) in order to provide a more coherent and thorough picture.

Notwithstanding the above, this study provides insights into the history and details of market conduct regulation and in doing so, provides an original and theoretical contribution to the limited body of knowledge on the subject matter at hand. An increased awareness regarding the particulars of market conduct regulation will hopefully provide a valuable contribution to National Treasury, Parliament, policymakers, academics and the like.

10 ANNEXURES

10.1 Annexure 1- List of Terms as per the Unfair Contract Terms Directive

Unfair terms include those terms which have the object or effect of:

a) Excluding or limiting the legal liability of a seller or supplier in the event of the death of a consumer or personal injury to the latter resulting from an act or omission of that seller or supplier;
b) Inappropriately excluding or limiting the legal rights of the consumer vis-à-vis the seller or supplier or another party in the event of total or partial non-performance or inadequate performance by the seller or supplier of any of the contractual obligations, including the option of offsetting a debt owed to the seller or supplier against any claim which the consumer may have against him;
c) Making an agreement binding on the consumer whereas provision of services by the seller or supplier is subject to a condition whose realisation depends on his own will alone;
d) Permitting the seller or supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract;
e) Requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation;
f) Authorising the seller or supplier to dissolve the contract on a discretionary basis where the same facility is not granted to the consumer, or permitting the seller or supplier to retain the sums paid for services not yet supplied by him where it is the seller or supplier himself who dissolves the contract;
g) Enabling the seller or supplier to terminate a contract of indeterminate duration without reasonable notice except where there are serious grounds for doing so;
h) Automatically extending a contract of fixed duration where the consumer does not indicate otherwise, when the deadline fixed for the consumer to express this desire not to extend the contract is unreasonably early;
i) Irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;

j) Enabling the seller or supplier to alter the terms of the contract unilaterally without a valid reason which is specified in the contract;

k) Enabling the seller or supplier to alter unilaterally without a valid reason any characteristics of the product or service to be provided;

l) Providing for the price of goods to be determined at the time of delivery or allowing a seller of goods or supplier of services to increase their price without, in both cases, giving the consumer the corresponding right to cancel the contract if the final price is too high in relation to the price agreed when the contract was concluded;

m) Giving the seller or supplier the right to determine whether the goods or services supplied are in conformity with the contract, or giving him the exclusive right to interpret any term of the contract;

n) Limiting the seller's or supplier's obligation to respect commitments undertaken by his agents or making his commitments subject to compliance with a particular formality;

o) Obliging the consumer to fulfil all his obligations where the seller or supplier does not perform his;

p) Giving the seller or supplier the possibility of transferring his rights and obligations under the contract, where this may serve to reduce the guarantees for the consumer, without the latter's agreement;

q) Excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract.

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