Financial Services Authority

FINAL NOTICE

To: **NICHOLAS BROWN**

Of: **44 Charlotte Avenue**
Wickford
Essex
SS12 0DZ

Date: **7 December 2007**

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice about a decision to make a prohibition order against you:

1. THE ACTION

1.1 The FSA gave you a Decision Notice on 18 October 2006 which notified you that pursuant to section 56 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to make an order prohibiting you from performing any function in relation to any regulated activity carried on by an authorised or exempt person or exempt professional firm ("the Prohibition Order").

1.2 You did not refer the matter to the Financial Services and Markets Tribunal. Accordingly, and for the reasons set out below, the FSA hereby makes the Prohibition Order against you, effective from the date of this Final Notice.

2. REASONS FOR THE ACTION

2.1 The FSA's action is based on the findings made against you by the High Court in the case of *Sphere Drake Insurance Limited and Another v Euro International Underwriting Limited and Others* [2003] EWHC 1636 (Comm) in which you were a defendant as a result of your conduct as a broker placing gross loss making business in the reinsurance market in the 1990s. As more fully set out in the Summary of Facts and Conclusions annexed below, the High Court found that Sphere Drake received claims in excess of $250 million as a result of the gross loss making business passed to it and that a claim against you for dishonestly assisting in a breach of fiduciary duty succeeded (you were described as "*the driving force in the dishonest enterprise*"). The judge also found that you gave untruthful evidence during the trial.

3. IMPORTANT

3.1 The decision which gave rise to the obligation to give this Final Notice was made by the Regulatory Decisions Committee on behalf of the FSA. This Final Notice is given to you and those persons to whom the Decision Notice was copied in accordance with section 390 of the Act.

Publicity

3.2 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this Final Notice relates. Under these provisions, the FSA must publish such information about the matter to which this Final Notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

3.3 The FSA intends to publish this Final Notice and such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

3.4 For more information concerning this matter generally, you should contact Dan Enraght-Moony (direct line: 020 7066 0166/fax: 020 7066 0167) or Richard Powell (direct line: 020 7066 0528/fax: 020 7066 0529).

Tracey McDermott
Head of Department
FSA Enforcement Division

ANNEX – SUMMARY OF FACTS AND CONCLUSIONS

1. REASONS FOR THE ACTION

Facts and matters relied on

1.1 The proposed action arises from the findings of dishonesty made against you in the judgment of Mr Justice Thomas in the case of Sphere Drake Insurance Limited & Anr v Euro International Limited & Ors [2003] EWHC 1636 (Comm) (the "Sphere Drake case") in which you were a defendant. Unless indicated otherwise paragraph references in this warning notice are taken from the judgment of Mr Justice Thomas cited above. The sections below set out:

1.1.1 An overview of the Sphere Drake case;

1.1.2 The key findings of Mr Justice Thomas; and

1.1.3 The key conclusions of Mr Justice Thomas.

An overview of the Sphere Drake case.

The business of trading in losses generated by Workers' Compensation Insurance

1.2 The Sphere Drake case arose out of the operation of a reinsurance market in the 1990s which traded in losses generated by US Workers' Compensation Insurance ("WC"). One of the ways in which alternative WC insurance operated was that the greater part of a standard WC policy would be reinsured after business comprising section B of the Workers' Compensation Act had been carved out (Section B business was then reinsured separately). This reinsurance was known as "WC carve out". The relevant market operated as follows (see Part I paragraph 5):

1.2.1 A reinsurer ("A") provided reinsurance at a premium which was far less than the amount that A expected it would have to pay out by way of claims. A did so only on the basis that it had outwards reinsurance by way of retrocession at a price that enabled it (1) to pay a small portion of each loss by way of retention, (2) to pay the premiums for its own outwards reinsurance, and (3) to make a small profit.

1.2.2 A's reinsurer, "B", would receive substantially less premium than A but would be liable for the greater part of the losses. B was prepared to write the retrocession only on the basis that it in turn had a retrocession (to reinsurer "C") on the basis of which B could make a net profit.

1.2.3 C in turn accepted the business on the basis that it had obtained its own reinsurance by way of retrocession from D; and so on.

1.3 The relevant reinsurers wrote such business knowing that the business would make losses in excess of the premium charged, and thus did not assess risk and premium in the conventional way: they wrote the business solely on the basis that they would make a net profit (or "turn"). The brokers who arranged the reinsurances earned

brokerages at a rate of at least 10% to 15% on each trade, further eroding the amount of premium that was available to pay losses.

1.4 This practice is sometimes referred to as "loss arbitraging", "net underwriting", writing "below the burn" or writing "gross loss making business". Mr Justice Thomas accepted the description of the practice as "pass the parcel" or "Russian roulette by proxy" (see Part I paragraph 7(xiii)).

1.5 The result of the practice (see Part I paragraph 7) was that losses were passed round and round between various reinsurers and retrocessionaires in the market. When heavy losses arose under US Workers' Compensation policies, several participants in the relevant market who had believed that they were writing catastrophe layers for relatively little premium found that they were actually in the position of first-tier reinsurers exposed to working layer losses. This resulted in extensive litigation in the US and elsewhere.

1.6 Mr Justice Thomas found (Part I paragraph 10) that "*the market which traded in losses in this way was one in which no rational and honest person would participate (either by committing his capital or by writing a line on a reinsurance of the business) if he had understood the market and proper disclosure had been made* ".

The Sphere Drake Case

1.7 Sphere Drake Insurance Limited ("SD"), as reinsurers, brought the clam against:

1.7.1 Euro International Underwriting Limited ("EIU"), who held their binding authority;

1.7.2 Stirling Cooke Brown Insurance Brokers Limited and Stirling Cooke Brown Reinsurance Brokers Limited (collectively referred to as "SCB") who were the brokers; and

1.7.3 Some of the individuals concerned of whom you were one.

1.8 Without the consent or knowledge of SD, EIU wrote contracts under the binding authority which constituted "gross loss making business", i.e. "*business on which it was virtually inevitable, from the information provided, that the losses under the reinsurance would exceed the premium by a substantial margin*" (Part I paragraph 151). This gross loss making business was described by Mr Justice Thomas as "*a type of business that if properly described, no prudent person would touch*" (Part I paragraph 308). EIU had no authority to write gross loss making business under the binding authority, which fact was known to SCB.

1.9 You were employed by SCB and were responsible for broking gross loss making business to EIU. In addition to the action brought against you, SD also brought a claim against EIU for dishonest breach of fiduciary duty. SD accused SCB of dishonestly assisting EIU in the breach of EIU's fiduciary duties (Part I paragraph 35 and following).

1.10 The total losses claimed from SD as a result of the 112 contracts written by EIU through SCB amounted to approximately US$250 million as at the date of the

judgment.

1.11 Mr Justice Thomas found in favour of SD on all material grounds. He held that the claims for dishonest breach of fiduciary duty succeeded against you. The FSA considers that the findings of dishonesty are particularly serious because of the scale of the losses suffered by the Claimant in the Sphere Drake case, and the potential risk that you would pose to the FSA's regulatory objectives were you to return to the market.

The key findings of Mr Justice Thomas

Role

1.12 Mr Justice Thomas found that, when you joined SCB in August 1992, you "*basically ran the company… everything went through"* you (Part I paragraph 356). However, "*as the company got bigger,* [a Director of SCB, hereinafter referred to as the "SCB Director"] *stepped into Mr Brown's role; they both tried to know what the other was doing and about what was going on within the company*" (Part I paragraph 356).

Deliberate creation of spirals in the market

1.13 In relation to the creation of spirals in the market between 1993 and 1996, Mr Justice Thomas found that "*Mr Brown was a man driven by the determination to achieve the plans for his group…To this end he was prepared to be quite ruthless. He understood from his long experience in the market the difference between what was honest and proper by the ordinary standards of the market and what was not,*" including understanding that "*it would be dishonest to construct an artificial spiral that was intended to, and would have the effect of, pushing working layer losses up to higher layers*" (Part I paragraphs 526).

1.14 Mr Justice Thomas went on to state that he was "sure":

1.14.1 "*that the spirals for 1993-6 were deliberately created*" (Part I paragraph 535); and

1.14.2 that you and the SCB Director "*understood and intended that the effect of the spirals was to push working layer losses (particularly those in 1995 and 1996) up to layers where catastrophe losses would ordinarily be experienced*" (Part I paragraph 536).

1.15 Mr Justice Thomas further held that you and the SCB Director "*did not care who wrote the losses at the higher layers as long as they were of sufficient security to pay for them. They were not selecting a particular reinsurer as a dump but were constructing a mechanism where the losses would be carried away from them and reinsured at very cheap rates; there was a prospect that the reinsurers would not realise the true extent of the losses being passed on to them as the delays inherent in a spiral would delay the notification and transmission of the losses"* (Part I paragraph 535(xiv)).

1.16 Mr Justice Thomas found that "*the motivation of SCB, Mr Brown and* [the SCB Director] *was (i) to enable those in the SCB group to compete more effectively in the*

market for WC [workers' compensation] and alternative WC in the US and to expand its operations… The provision of cheap reinsurance… enabled SCB to be more competitive; [and]*... to earn very considerable commissions of 10%-15% which were paid each time the same business was passed round and round*" (Part I paragraph 541).

1.17 In relation to the spiral created at the end of 1997, Mr Justice Thomas found that "*SCB (through Mr Brown and* [the SCB Director]*) and* [an employee of EIU hereinafter referred to as the "EIU employee"] *were well aware that the effect of the writing of the Christmas Eve [1997] programmes would be to create more gross loss making business that would then be put into the spiral… they knew that one of the objectives of a spiral was to push working layer losses up to catastrophe layers which would not, in a conventional market, anticipate working layer losses*" and that they "*knew that the creation of this spiral would delay the payment of these losses for very many years and that this would enable them to continue to broke this gross loss making business*" (Part I paragraphs 1259-1262).

Conduct in relation to EIU and the SD binder

1.18 The effect of the first three programmes written under the binder (relating to a deal with Phoenix and American Reliable) was that, by March 1997, "*there was a funnel which ended up by concentrating or funnelling the losses above the combined retention of JEH Re, American Reliable and Phoenix… into SD"* (Part I paragraph 838).

1.19 Mr Justice Thomas held that SCB "*must have understood that the broad effect of the agreements that had been made was to funnel the losses to SD*" (Part I paragraph 841). Mr Justice Thomas held that you acted "*in a dishonest manner, knowing full well that SD had no knowledge of what had been done and that the losses they and their reinsurers would incur might well be enormous as a direct result of the dishonest arrangements"* you had constructed, and that your "*evidence in relation to the deal was untruthful"* (Part I paragraph 858(ii)).

1.20 In general terms, regarding the business written for SD through the first five programmes, Mr Justice Thomas concluded:

> *"Mr Brown and* [the SCB Director] *and through them, SCB, knew from that time* [27 February 1997] *that EIU were deliberately concealing what they were doing from SD and were dishonestly assisting them in their breach of fiduciary duties" (*Part I Paragraph 885).
>
> and
>
> *"SCB knew from early February 1997 that EIU had no authority to write gross loss making business and had dishonestly assisted them in breach of their fiduciary duty…SCB ruthlessly exploited the opportunity offered through the binder from the outset to further their interests and ambitions* (Part I paragraph 1247(i)).
>
> and
>
> *"SCB dishonestly assisted EIU in the writing of all the business that was written by*

EIU for SCB and its clients, and this was done from no later than 3 February 1997; as all the programmes other than Programmes 1, 4 and 5 were written after that date, the dishonest assistance extends to all contracts". (Part I paragraph 888). In addition, SCB knew, prior to the confirmation of the programmes, that SD were unaware of the nature of the business being written in respect of Programmes 1, 4 and 5 as well. (Part I paragraph 888).

1.21 Mr Justice Thomas found that you *"acted ruthlessly in withholding the quotation until the last minute and in making it clear to* [the EIU employee] *that* [the EIU employee] *had to write the business offered or EIU would not get the reinsurance they desperately needed for 1997 and 1998* [you] *put* [the EIU employee] *in the position where he had no real alternative other than to accept the offer to write the programmes presented in return for reinsurance.* [The EIU employee] *acquiesced in this*." (Part 1 Paragraphs 1243 (vii) and 1246).

The key conclusions of Mr Justice Thomas

1.22 Mr Justice Thomas found that a claim for dishonest assistance succeeded against you (Part I paragraph 1863). He described you as *"the driving force in the dishonest enterprise which I have described in this judgment… motivated by ambition to make SCB a full-service insurance company and by greed in earning large sums of money through the brokerage of business provided…* [you] *set about achieving …*[your] *ambition with ruthlessness and where it suited* [your] *purpose, with singular dishonesty*" (Part I paragraph 1861).

1.23 Secondly, Mr Justice Thomas found that you had been involved, in the period from 1993 to 1996, in the deliberate creation of spirals in the market which were intended to push working layer losses up to layers where catastrophe losses would ordinarily be experienced (Part I paragraphs 535 and 536). Mr Justice Thomas also held that you understood that it was "*dishonest to construct an artificial spiral*" which had that effect (Part I paragraph 526).

1.24 Thirdly, Mr Justice Thomas stated that that you had given untruthful evidence during the trial: indeed, he stated that you were a witness "*who gave dishonest and untruthful evidence in relation to many matters*" (Part I paragraph 1254).

Conclusions

2.1 Pursuant to FIT 2.1.1 G (2), (10) and (11), the FSA has had regard to the facts and matters described in the Sphere Drake case above. As a result the FSA has concluded that you do not appear to be a fit and proper person to perform any function in relation to any regulated activity carried on by any authorised or exempt person or exempt professional firm.

2.2 The FSA has further concluded that the severity of the risk that you pose to consumers and to confidence in the market generally is such that it is necessary, in light of its regulatory objectives, for the FSA to exercise its power to make a prohibition order against you.