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## FINAL NOTICE

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To: Sun Life Assurance Company of Canada (UK) Limited

FSA Reference Number: 110481

Address: Matrix House  
Basing View  
Basingstoke  
Hampshire  
RG21 4DZ

Date: 18 October 2012

### **1. ACTION**

- 1.1. For the reasons given in this notice, the Financial Services Authority (the FSA) imposes on Sun Life Assurance Company of Canada (UK) Limited (SLOC UK or the Firm) a financial penalty of £600,000. The penalty is for breaches of Principle 3 (management and control) of the FSA's Principles for Businesses (the Principles) and rules set out in the FSA Handbook, namely rules in the Prudential Sourcebook for Insurers (INSPRU) and the Supervision Manual (SUP). The breaches occurred between 1 November 2008 and 26 August 2009 (the Relevant Period).
- 1.2. SLOC UK agreed to settle at an early stage of the FSA's investigation. SLOC UK therefore qualified for a 20% (Stage 2) discount under the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a financial penalty of £750,000.

### **2. SUMMARY OF REASONS**

- 2.1. SLOC UK is a life insurer operating a closed book of business including with-profits business. During the Relevant Period, SLOC UK's governance arrangements for its with-profits business were unclear and inadequate both in their design and in their practical operation. As a result, there was an unacceptably high risk that policyholders' interests would not be protected properly.

- 2.2. These failings were evidenced when SLOC UK executed two significant and material derivative transactions over one of its with-profits funds which held approximately 114,000 policies and £1.2 billion in assets. SLOC UK executed these transactions without adequate review from its with-profits committee. These transactions were also executed without the approval of SLOC UK's board of directors albeit the majority of the directors were aware of the proposed transactions. This approval process was deficient and led to an unacceptable risk that proper independent judgment would not be applied to the transactions.
- 2.3. Furthermore, at the time that SLOC UK executed the second of the material transactions, the Inherited Estate of this with-profits fund had a negative value which is a breach of the FSA's rules. SLOC UK also breached the FSA's rules by failing to report the negative value of the Inherited Estate to the FSA in a timely manner.
- 2.4. The FSA regards SLOC UK's failings as particularly serious because they occurred at a time when there was a high level of awareness within the with-profits sector of the regulatory standards concerning the governance arrangements for with-profits funds, and the need for with-profits committees to provide independent and appropriate challenge to management on significant decisions concerning policyholders. In particular, a "Dear CEO" letter dated 19 September 2007 was sent to the CEOs of insurers which set out the FSA's expectations in terms of governance standards for with-profits businesses.
- 2.5. SLOC UK's failures therefore merit the imposition of a significant financial penalty. In deciding upon the level of disciplinary sanction, the FSA has:
- (1) not criticised the merits of the two transactions executed by SLOC UK over its with-profits fund during the Relevant Period;
  - (2) recognised that some consideration was given by SLOC UK to its policyholders' interests albeit there were significant flaws in the governance arrangements to ensure that independent judgment by SLOC UK's with-profits committee was exercised properly; and
  - (3) taken account of SLOC UK's efforts to improve the effectiveness of its governance arrangements and SLOC UK's implementation of recommendations of a review by a skilled person.

### **3. DEFINITIONS**

- 3.1. The definitions below are used in this Final Notice.

"the Act" means the Financial Services and Markets Act 2000

"the Board" means the Board of Directors of SLOC UK

"the CEO" means the Chief Executive Officer of SLOC UK

"COBS" means the Conduct of Business Sourcebook which is part of the FSA Handbook

“DEPP” means the Decision Procedure and Penalties Manual which is part of the FSA Handbook

“EBR” means the percentage of the Fund invested in equities and property holdings

“EG” means the Enforcement Guide which is part of the FSA Handbook

“the Firm” means Sun Life Assurance Company of Canada (UK) Limited

“the First PSC” means the put spread collar which was executed by SLOC UK on 3 and 4 December 2008

“the FSA” means the Financial Services Authority

“the FSA Handbook” means the FSA’s handbook of rules and guidance

“the Fund” means the closed with-profits fund within which the PSCs were executed

“the Inherited Estate” means the excess of assets over realistic liabilities in the Fund

“INSPRU” means The Prudential Sourcebook for Insurers which is part of the FSA Handbook

“the ISC” means SLOC UK’s investment strategy committee

“the PPFM” means the Principles and Practices of Financial Management which is a document made available to policyholders informing them about how SLOC UK manages the Fund. The FSA requires all firms running with-profits business to establish and maintain a PPFM

“The Principles” means the FSA’s Principles for Businesses which are part of the FSA Handbook

“the PSCs” means the First PSC and the Second PSC

“the Relevant Period” means the period of 1 November 2008 to 26 August 2009

“the Second PSC” means the restructuring of the First PSC which took place on 18 March 2009

“SLOC UK” means Sun Life Assurance Company of Canada (UK) Limited

“SUP” means the Supervision Manual which is part of the FSA Handbook

“SYSC” means the Senior Management Arrangements Systems and Controls Sourcebook which is part of the FSA Handbook

“the WPA” means SLOC UK’s with-profits actuary. Firms running with-profits business are required by the FSA to employ a with-profits actuary

“the WPC” means SLOC UK’s with-profits committee

“the WPMC” means SLOC UK’s with-profits management committee

## **4. FACTS AND MATTERS**

### **SLOC UK**

- 4.1. SLOC UK is a life insurer administering a closed book of life assurance and pension products. It is a wholly-owned subsidiary of Sun Life Financial Inc, an international financial services group based in Toronto, Canada. SLOC UK has been authorised by the FSA since 1 December 2001 to perform a number of regulated activities, including carrying out and effecting contracts of insurance.
- 4.2. SLOC UK operates a closed with-profits fund (the Fund) which held approximately 114,000 life insurance and pension policies and £1.2 billion in assets as at 31 December 2008.

### **The with-profits sector**

- 4.3. The FSA views effective governance arrangements as critically important in firms which run with-profits business. This is because with-profits business, by virtue of their nature and the extent of discretion applied by firms in their operation, involve numerous potential conflicts of interest that might give rise to the unfair treatment of policyholders. This was stated in the FSA's guidance on with-profits business contained in chapter 20 of the Conduct of Business Sourcebook (COBS) which was in force during the Relevant Period.
- 4.4. As part of the FSA's focus on protecting with-profits policyholders, the FSA embarked on major regulatory reform of the with-profits sector in 2001. Consequently, in 2005, the FSA introduced new rules for with-profits funds which were designed to ensure that policyholders were treated fairly and to provide further transparency and accountability within the with-profits sector. In 2007, the FSA conducted reviews of firms' with-profits businesses in an attempt to ensure that the FSA's rules were complied with and understood. These reviews revealed weaknesses around the protection of with-profits policyholders' interests, in particular in relation to the general lack of independent challenge provided by firms' with-profits committees. The FSA found as part of its review in 2007 that the with-profits sector did not work as effectively as it should in terms of the governance of with-profits funds which resulted in poor outcomes for policyholders.

### ***The "Dear CEO" letter***

- 4.5. During 2007, the FSA conducted a thematic review in respect of the appropriateness of governance arrangements for with-profits funds (including with-profits committees). During this review, the FSA found that some firms were not doing enough to provide independent input into the management of with-profits funds.
- 4.6. The FSA issued a "Dear CEO" letter in September 2007 setting out its key findings from the thematic review and asking the senior management of insurers running with-profits funds to review the FSA's findings and to take prompt action to address any shortcomings those insurers identified in their own governance arrangements.
- 4.7. The main findings set out in the "Dear CEO" letter included:

- (1) senior management needed to ensure that a firm's with-profits governance arrangements (such as a with-profits committee) were consulted on all significant issues affecting with-profits policyholders' interests;
- (2) in some firms, the range of issues referred to the firm's with-profits governance arrangements (such as a with-profits committee) was more limited than the FSA would expect;
- (3) in some instances, with-profits committees were only being told of significant decisions after they had been made or were being given insufficient time to review and challenge significant decisions; and
- (4) CEOs should consider whether their with-profits governance arrangements achieve the purpose intended, specifically whether they are delivering the outcome of fair treatment of with-profits policyholders. The FSA expected firms to take prompt action to remedy any shortcomings.

4.8. Further details from the relevant sections of the "Dear CEO" letter are set out in the Annex to this Final Notice.

#### **The design of SLOC UK's governance arrangements for its with-profits business**

4.9. During the Relevant Period, SLOC UK designed the governance arrangements for its with-profits business to comprise the following bodies:

- (1) the board of directors (Board);
- (2) the with-profits committee (WPC);
- (3) the investment strategy committee (ISC); and
- (4) the with-profits management committee (WPMC).

4.10. In accordance with the FSA's requirement for firms running with-profits business to appoint a with-profits actuary, SLOC UK appointed a with-profits actuary (WPA) to advise management on the use of discretion as it affects policyholders. The WPA was a member of the ISC (for matters pertaining to the Fund) and the WPMC, and also attended some WPC and Board meetings.

#### ***The Board***

4.11. The Board had overall responsibility for the conduct of the with-profits business and the fair treatment of with-profits policyholders.

4.12. The Board had no terms of reference which meant that there was no record of the matters which were reserved for the Board's review and approval. The Board delegated some of its duties to its standing committees, including the ISC. The ISC's terms of reference revealed that some duties had been delegated to it by the Board but the scope of these delegated duties was unclear.

## WPC

- 4.13. SLOC UK's WPC was established because the FSA requires firms to take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system, and for countering the risk that the firm might be used to further financial crime. The FSA's guidance for firms carrying on with-profits business states that, in complying with this FSA requirement, a firm should maintain governance arrangements which are appropriate to the scale and complexity of its with-profits business and designed to ensure that it complies with, maintains and records a Principles and Practices of Financial Management (PPFM). The FSA's guidance goes on to state that these governance arrangements should involve some independent judgment in assessing compliance with the firm's PPFM and addressing conflicting rights and interests of policyholders and, if applicable, shareholders, and that such governance arrangements could include establishing a with-profits committee. A "*with-profits committee*" is defined in the FSA Glossary as:

*"a committee of the governing body, including non-executive members of the governing body and possibly some external non-directors with appropriate skills and experience."*

- 4.14. SLOC UK chose to establish a with-profits committee as part of its governance arrangements and as its means of ensuring that independent judgment was applied to any conflict between the rights and interests of policyholders and the shareholder, and assessing compliance with its PPFM. During the Relevant Period, according to its terms of reference, the WPC had responsibility for:
- (1) ensuring that SLOC UK met its regulatory responsibilities to its policyholders;
  - (2) ensuring that SLOC UK complied with its PPFM;
  - (3) ensuring that SLOC UK's policyholders were treated fairly;
  - (4) ensuring that SLOC UK exercised its discretion in a way that equitably addressed the competing or conflicting rights of policyholders;
  - (5) reviewing any proposals from SLOC UK that impact on the payouts to policyholders; and
  - (6) reviewing financial matters that impact on the financial position of the Fund including, but not limited to, investment strategy and significant investment transactions.
- 4.15. The WPC's terms of reference did not define "*significant investment transactions*" and they did not explain how the WPC would be informed of "*investment strategy*" or "*significant investment transactions*" impacting on the Fund in order to be able to review such matters. It was also unclear from the WPC's terms of reference whether the WPC's review should take place prior to or after any such "*proposals*" or "*financial matters*" had been implemented by SLOC UK.

## **ISC**

- 4.16. The ISC was responsible for investment strategy, compliance with investment policies and investment monitoring of all of SLOC UK's funds, including the Fund. Its membership comprised of mainly executives and there were no non-executive directors on the ISC. The ISC also included SLOC UK's WPA for matters pertaining to the Fund.
- 4.17. The ISC's terms of reference gave a brief description of matters that should be referred to the Board such as any change in asset managers, any management proposal to create, dispose or amalgamate any of SLOC UK's unit linked or general account funds and recommendations relating to the ISC's terms of reference. The terms of reference permitted the ISC to approve portfolio hedging transactions (including cashless equity collars) but also stated that, "*where required*", the ISC should recommend portfolio hedging transactions to the Board. However, the terms of reference did not clarify *when* this would be required. Furthermore, the ISC's terms of reference did not provide any guidance on whether material and significant transactions should be escalated to the Board. The scope of responsibilities delegated by the Board to the ISC was therefore unclear.
- 4.18. The ISC's terms of reference made no provision for the ISC to refer matters to the WPC for review. This is despite the likelihood that the ISC would originate "*proposals*" and "*financial matters*" impacting on the Fund and its policyholders which the WPC was tasked through its terms of reference to review.

## **WPMC**

- 4.19. The WPMC's terms of reference stated that the WPMC provided operational management of SLOC UK's with-profits business and, as a result, its membership did not include non-executive directors. Unlike the WPC and the ISC, the WPMC was not a standing committee of the Board and did not report to the Board. It also did not report to either the ISC or the WPC and its terms of reference did not provide any guidance on how the WPMC should interact with the ISC or the WPC. The WPMC had no authority to approve investment decisions.
- 4.20. According to their respective terms of reference, the WPC and the WPMC both had responsibility for:
- (1) ensuring that SLOC UK exercised its discretion in a way that ensured that policyholders had been treated fairly;
  - (2) ensuring that SLOC UK was compliant with its PPFM; and
  - (3) looking at the way in which SLOC UK had addressed conflicts of interest between policyholders and the shareholder.
- 4.21. However, it was not clear from their respective terms of reference how these responsibilities were divided between the WPC and the WPMC. There was no guidance on how the WPC and the WPMC should interact to ensure that they were clear about how and when they would share responsibilities.

### **The Put Spread Collars (PSCs)**

- 4.22. The way in which SLOC UK's governance arrangements for its with-profits business operated in practice was demonstrated when SLOC UK executed put spread collars over the Fund in December 2008 and March 2009. A put spread collar is a type of derivative transaction. The PPFM permitted the use of derivatives for risk management purposes and derivatives had been used by the Fund in the past for this purpose.
- 4.23. During 2008 the equity markets were very turbulent with declines in the value of equities. In November 2008, SLOC UK identified that the Fund was at risk of becoming insolvent if the value of equities in the Fund continued to fall. As part of its investment strategy to address the potential impact of further equity market falls on the Fund, it decided to enter into a 12-15 month put spread collar.
- 4.24. This transaction was executed at the beginning of December 2008 (the First PSC). In March 2009, following further falls in the equities market and continued risks to the solvency of the Fund; SLOC UK restructured the First PSC (the Second PSC). The PSCs were designed so that, for the term of the derivatives, the Fund would be protected against falls in the value of equities down to a set level of the FTSE 100 in return for giving away the benefit of rises in the value of equities above a set level of the FTSE 100.

### **Significant and material transactions**

- 4.25. The PSCs were significant and material transactions in terms of their size, their impact on the investments of the Fund and hence on returns to policyholders. The PSCs covered nearly all of the Fund's equity holdings (approximately £300 million worth of equities). The significance and materiality of the PSCs can be explained with reference to their impact on the Fund's equity backing ratio (EBR) both as individual transactions and in combination. The EBR is the percentage of the Fund invested in equities and property holdings. The FSA estimates that the First PSC had an immediate impact broadly equivalent to halving the equity portion of the EBR (the proportion of the Fund invested in equities) from approximately 30% to approximately 15%. The FSA estimates that the Second PSC had an immediate impact broadly equivalent to halving the remaining equity portion of the EBR from approximately 15% to approximately 7.5%. This means that the PSCs had an overall impact broadly equivalent to reducing the amount of equities in the Fund from approximately 30% to approximately 7.5%. Implementing the PSCs did not alter the direct holdings of equities in the Fund but it changed the exposure of the Fund to the performance of the equity markets during the term of the derivatives because each PSC consisted of derivatives linked to the FTSE 100 Index. The PSCs therefore made material changes to the effective EBR of the Fund for the duration of the derivatives.

### **The operation of the governance arrangements as illustrated by the PSCs**

- 4.26. SLOC UK's execution of the PSCs demonstrated how its with-profits governance arrangements operated in practice.



### ***First PSC***

- 4.27. The ISC was the committee that took the decision to enter into the First PSC. This decision was based on a PowerPoint presentation which was presented to the ISC by the Actuarial Function Holder, one of the ISC members. This presentation contained a detailed analysis of possible actions that could be taken by SLOC UK in relation to the Fund, including the execution of a put spread collar. The presentation had been circulated to members of the ISC including the WPA for review and comment prior to the ISC meeting.
- 4.28. The ISC did not refer its decision to execute the First PSC to the WPC for review but instructed the CEO of the Firm to telephone the WPC members separately to inform them of the ISC's decision to enter into the First PSC. Not every member of the WPC had received a copy of the PowerPoint presentation. The WPC did not object to the proposed transaction. The WPC members did not speak or hold a WPC meeting after receiving these telephone calls from the CEO.
- 4.29. Prior to these telephone calls, SLOC UK's WPA had raised a concern about the First PSC potentially giving rise to a conflict between the interests of policyholders and the shareholder. Despite this, the WPC was not informed of this concern at any time. The WPA confirmed later that he was satisfied that his concern had been addressed.
- 4.30. Despite choosing to adopt governance arrangements for its with-profits business which included its WPC applying independent judgment to any conflict between the interests of policyholders and the shareholder, SLOC UK's WPC did not adequately review the First PSC. The First PSC was a significant and material transaction impacting on SLOC UK's Fund and its policyholders and a proper review of the First PSC should have fallen within the WPC's remit. However, the WPC's remit was not clear from its terms of reference.
- 4.31. Furthermore, the ISC's terms of reference did not contain any provisions to ensure that decisions taken by the ISC which impacted on the Fund and its policyholders (such as the First PSC) would be referred to the WPC.
- 4.32. The ISC also gave no consideration to whether it needed to refer its decision to execute the First PSC to the Board for review or approval, and did not in fact refer its decision to the Board, despite the fact that its terms of reference identified (albeit with a significant lack of clarity) that certain transactions would need to be referred to the Board for approval. The First PSC was a "*portfolio hedging transaction*" which, according to its terms of reference, the ISC should recommend to the Board where required.
- 4.33. The ISC referred its decision to the WPMC and the WPMC agreed with it.

### ***Second PSC***

- 4.34. Following the execution of the First PSC, the Fund was still at risk of becoming insolvent if equity markets continued to decline. A paper setting out further actions that could be taken to protect the Fund was prepared for the ISC. The ISC discussed this paper in a meeting and ultimately decided to restructure the First PSC.

- 4.35. Again, the ISC did not refer its decision to either the WPC or the Board for review or approval.
- 4.36. One of the WPC members had received the paper prepared for the ISC and had discussed this paper informally and in high level terms with the CEO. He had also been copied in on emails between the ISC members which discussed whether the Second PSC should be executed. However, another member of the WPC did not receive the ISC paper or emails and did not know that a second put spread collar would be executed until after the Second PSC had been implemented. The WPC did not hold a meeting or discuss the Second PSC.
- 4.37. The ISC referred its decision to the WPMC and the WPMC agreed with it.
- 4.38. In summary, the PSCs, which were significant and material transactions impacting the Fund and its policyholders, were executed by SLOC UK even though:
- (1) the ISC did not refer its decisions to execute the PSCs to the WPC; and
  - (2) the ISC did not recommend the PSCs to the Board for approval.

#### **The negative position of the Inherited Estate**

- 4.39. The Fund's Inherited Estate had a negative value when the Second PSC was executed but SLOC UK was not aware of this at the time. The Inherited Estate consists of assets in excess of realistic liabilities within the Fund. SLOC UK seeks to maintain the Inherited Estate at an appropriate percentage of the Fund and it is used, among other purposes, to help provide capital support to the Fund. The FSA's rules state that the Inherited Estate must have a positive value. If the Inherited Estate does go negative, the firm concerned is required under the FSA's rules to inform the FSA.
- 4.40. In early July 2009, following an update of an estimate with more accurate calculations, SLOC UK's actuarial department became aware that the Inherited Estate had a negative value as at 31 March 2009 (with this continuing to be the case until late April 2009). The CEO became aware of the negative Inherited Estate when she received papers for a WPMC meeting scheduled for 14 August 2009, and the Board was informed on 19 August 2009 when papers for a forthcoming Board meeting were circulated. The FSA was informed of the Inherited Estate having a negative value on 26 August 2009 by which time it had been more than five months since the Inherited Estate had first become negative.

## **5. FAILINGS**

- 5.1. SLOC UK had an obligation to comply with Principle 3 of the FSA's Principles by taking reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. SLOC UK was also required to comply with SUP 15.3.11 R and INSPRU 1.1.28 R. These rules and the regulatory provisions relevant to this Final Notice are referred to in Annex A.
- 5.2. SLOC UK breached Principle 3 because the governance arrangements for SLOC UK's Fund were unclear and inadequate both in their design and in their practical operation.

- 5.3. The governance arrangements for SLOC UK's with-profits business were poorly designed because:
- (1) SLOC UK's governance arrangements included its WPC but the remit of the WPC's responsibilities was unclear from its terms of reference;
  - (2) it was not clear which matters had been reserved for the Board's review and approval because:
    - (a) the Board had no terms of reference explaining which matters had been reserved for its review and approval and which matters had been delegated to its standing committees; and
    - (b) although the ISC's terms of reference showed that some matters had been delegated to the ISC by the Board, the scope of the delegated duties was unclear;
  - (3) the terms of reference for the ISC and the WPC did not ensure that the ISC referred significant and material transactions affecting the Fund and its policyholders to the WPC for the WPC's review;
  - (4) the WPC and the WPMC shared responsibility for the same matters despite the difference in their composition and purpose. In particular:
    - (a) it was unclear from their respective terms of reference how their responsibility was shared; and
    - (b) there was no guidance on how the WPC and the WPMC should interact to ensure that they were clear about how and when they would share their responsibility.
- 5.4. As a consequence of the WPC failing to adequately review the PSCs, the committee which had the specific purpose and the independent membership required by the FSA to apply its independent judgment to addressing conflicts between the interests of policyholders and the shareholder did not adequately review the PSCs.
- 5.5. As a consequence of SLOC UK's Board failing to approve the PSCs, the governing body of SLOC UK which had ultimate responsibility for the Fund failed to review and approve significant and material transactions impacting on the Fund and its policyholders.
- 5.6. The fact that the PSCs were not referred to the Board is a failing on its own and a more serious failing when viewed alongside SLOC UK's failings in relation to the WPC. Where decisions to execute significant and material transactions such as the PSCs bypass both the WPC and the Board, non-executive directors may have insufficient opportunity to properly review these transactions with the result that these transactions might not receive adequate independent challenge.
- 5.7. SLOC UK also breached:
- (1) INSPRU 1.1.28 R by failing to maintain a positive value for its Inherited Estate; and

- (2) SUP 15.3.11 R by failing to report the negative value of the Inherited Estate to the FSA in a timely manner.

## **6. SANCTION**

- 6.1. The FSA has considered the disciplinary and other options available to it and has concluded that a financial penalty is the appropriate sanction in the circumstances of this particular case. The principal purpose of a financial penalty is to promote high standards of regulatory conduct. It seeks to do this by deterring firms who have breached regulatory requirements from committing further contraventions and demonstrating generally to firms the benefit of compliant behaviour.
- 6.2. The FSA's policy on the imposition of financial penalties and public censures is set out in the Enforcement Guide (EG) and the Decision Procedure and Penalties Manual (DEPP). The FSA introduced a new policy for imposing a financial penalty on 6 March 2010. In this case, as the Relevant Period is 1 November 2008 to 26 August 2009, the breach falls under the old FSA penalty policy. Accordingly, the FSA has applied the old policy to calculate the appropriate penalty for SLOC UK's breach. All references to DEPP below are therefore to the version in place prior to 6 March 2010.

### **Determining the level of financial penalty**

- 6.3. In determining the appropriate level of financial penalty, the FSA has had regard to all the relevant circumstances of the case and the factors set out in DEPP 6.5.2G. Of these factors in DEPP 6.5.2G, the FSA considers the following to be of particular relevance to this case.

### **Deterrence (DEPP 6.5.2(1))**

- 6.4. Firms that have poor systems and controls in relation to their with-profits business are a risk to with-profits policyholders and undermine the FSA's regulatory objective to protect consumers.
- 6.5. The FSA considers that the financial penalty imposed will promote high standards of regulatory conduct within SLOC UK and deter it from committing further breaches. The FSA also considers that the financial penalty will help to deter other firms from committing similar breaches and will reinforce the FSA's message that firms need to have in place clear and adequate governance arrangements in relation to their with-profits business to ensure that with-profits policyholders are fairly treated.

### **The nature, seriousness and impact of the breaches (DEPP 6.5.2(2))**

- 6.6. The FSA has had regard to the seriousness of the breaches including the duration of the breaches, whether the breaches revealed serious or systemic weakness of the management systems or internal controls and the potential impact on with-profits policyholders.
- 6.7. SLOC UK's breaches are viewed as particularly serious because:
  - (1) the PSCs were material and significant transactions. The FSA estimates that the execution of the PSCs was broadly equivalent to reducing the equity

portion of the EBR (the proportion of the Fund invested in equities) from approximately 30% to 15% in December 2008, and then from approximately 15% to approximately 7.5% in March 2009;

- (2) the unclear and inadequate governance arrangements led to an unacceptably high risk that the interests of SLOC UK's with-profits policyholders were not properly protected and taken into account in the actions taken by SLOC UK. This is of particular importance given the inherent potential for conflicts of interest arising from with-profits business; and
- (3) the breaches occurred at a time when there was a high level of awareness within the with-profits sector of the regulatory standards concerning the governance arrangements for with-profits funds, and the need for with-profits committees to provide independent and appropriate challenge to management on significant decisions concerning policyholders. In particular, a "Dear CEO" letter dated 19 September 2007 was sent to the CEOs of insurers concerning governance arrangements for with-profits funds.

#### **The extent to which the breach was deliberate or reckless (DEPP 6.5.2(3))**

- 6.8. The FSA does not consider that the misconduct on the part of SLOC UK was deliberate or reckless.

#### **The size, financial resources and other circumstances of the firm (DEPP 6.5.2(5))**

- 6.9. The FSA has taken into account SLOC UK's size and financial resources. The FSA has seen no evidence to suggest that SLOC UK is unable to afford the financial penalty.

#### **The amount of benefit gained or loss avoided (DEPP 6.5.2(6))**

- 6.10. The FSA accepts that SLOC UK did not financially benefit from its misconduct and that the PSCs were implemented with the objective of preserving the solvency of the Fund.

#### **Disciplinary record and compliance history (DEPP 6.5.2(9))**

- 6.11. The FSA has not previously taken any disciplinary action against SLOC UK.

#### **Conduct following the breach (DEPP 6.5.2(8))**

- 6.12. In deciding upon the level of disciplinary sanction, the FSA has taken account of SLOC UK's efforts to improve the effectiveness of its governance arrangements and SLOC UK's implementation of recommendations of a review by a skilled person.
- 6.13. SLOC UK has co-operated fully with the FSA in the course of its investigation.

#### **Previous action taken by the FSA (DEPP 6.5.2(10))**

- 6.14. The FSA seeks to apply a consistent approach to determining the appropriate level of penalty and has taken into account previous decisions made in relation to misconduct by firms which bore similarities to SLOC UK's misconduct.

- 6.15. Having regard to the seriousness of the breaches and the risk they posed to the FSA's statutory objective of the protection of consumers, the FSA imposes a financial penalty of £600,000 on SLOC UK.

## **7. PROCEDURAL MATTERS**

### **Decision maker**

- 7.1. The decision which gave rise to the obligation to give this Final Notice was made by the Settlement Decision Makers.
- 7.2. This Final Notice is given under, and in accordance with, section 390 of the Act.

### **Manner of and time for payment**

- 7.3. The financial penalty must be paid in full by SLOC UK to the FSA by no later than 1 November 2012, 14 days from the date of the Final Notice.

### **If the financial penalty is not paid**

- 7.4. If all or any of the financial penalty is outstanding on 2 November 2012, the FSA may recover the outstanding amount as a debt owed by SLOC UK and due to the FSA.

### **Publicity**

- 7.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this 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 SLOC UK or prejudicial to the interests of consumers.
- 7.6. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

### **FSA contacts**

- 7.7. For more information concerning this matter generally, contact Andrew Wigston of the Enforcement and Financial Crime Division of the FSA (direct line: 020 7066 6286/fax: 020 7066 6287).

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**Tom Spender**  
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## ANNEX A

### RELEVANT STATUTORY PROVISIONS, REGULATORY PROVISIONS AND FSA GUIDANCE

#### 1. STATUTORY PROVISIONS

1.1. Under Section 2(2) of the Act, the protection of consumers is one of the FSA's statutory objectives.

1.2. Section 206 of the Act provides:

*“If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate.”*

1.3. SLOC UK is an authorised person for the purposes of section 206 of the Act. The requirements imposed on an authorised person include those set out in the FSA Principles and rules made under section 138 of the Act.

1.4. The FSA's rule-making powers are set out in Chapter I of Part X of the Act (Rules and Guidance). The FSA has made rules, in particular those contained in SYSC, COBS, INSPRU and SUP in accordance with its powers and provisions under this part of the Act.

#### 2. REGULATORY PROVISIONS

##### **FSA's Principles and Rules**

2.1. The FSA's Principles are a general statement of the fundamental obligations of firms under the regulatory system. They derive their authority from the FSA's rule-making powers as set out in the Act and reflect the FSA's regulatory objectives.

2.2. Principle 3 states:

*“A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.”*

##### **FSA's Conduct of Business Sourcebook (COBS)**

2.3. COBS 20.3.2 G states:

*“In complying with the rule on systems and controls in relation to compliance, financial crime and money laundering (SYSC 3.2.6 R), a firm should maintain governance arrangements designed to ensure that it complies with, maintains and records any applicable PPFM. These arrangements should:*

- (1) be appropriate to the scale and complexity of the firm's with-profits business;*
- (2) include the approval of the firm's PPFM by its governing body; and*

- (3) *involve some independent judgment in assessing compliance with its PPFM and addressing conflicting rights and interests of policyholders and, if applicable, shareholders, which may include but is not confined to:*
- (a) *establishing a with-profits committee;*
  - (b) *asking an independent person with appropriate skills and experience to report on these matters to the governing body or to any with-profits committee; or*
  - (c) *for small firms, asking one or more non-executive members of the governing body to report to the governing body on these matters.*

***The FSA’s view on With-Profits Funds***

2.4. Through Chapter 20 of COBS which was in force during the Relevant Period, the FSA sought to protect policyholders of with-profits funds to ensure that they were not treated unfairly.

2.5. COBS 20.2.1G states:

*“With-profits business, by virtue of its nature and the extent of discretion applied by firms in its operation, involves numerous potential conflicts of interest, that might give rise to the unfair treatment of policyholders. The rules in this section [meaning the rules contained in COBS 20] address specific situations where the risk may be particularly acute. However, a firm should give careful consideration to any aspect of its operating practice that has a bearing on the interests of its with-profits policyholders to ensure that it does not lead to an undisclosed, or unfair, benefit to shareholders.”*

**FSA’s Senior Management Arrangements, Systems and Controls (SYSC)**

2.6. SYSC 3.2.6R states:

*“A firm must take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system and for countering the risk that the firm might be used to further financial crime.”*

**FSA’s Supervision Manual (SUP)**

2.7. SUP 15.3.11 R states:

*“(1) A firm must notify the FSA of:*

- (a) *a significant breach of a rule (which includes a Principle) or Statement of Principle; or*
- (b) *a breach of any requirement imposed by the Act or by regulations or an order made under the Act by the Treasury (except if the breach is an offence, in which case (c) applies);*



- (c) *the bringing of a prosecution for, or a conviction of, any offence under the Act;*
- (d) *a breach of a directly applicable provision in the MiFID Regulation; or*
- (e) *a breach of any requirement in regulation 4C(3) (or any successor provision) of the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007;*

*by (or as regards (c) against) the firm or any of its directors, officers, employees, approved persons, or appointed representatives or, where applicable, tied agents.*

- (2) *A firm must make the notification in (1) immediately it becomes aware, or has information which reasonably suggests, that any of the matters in (1) has occurred, may have occurred or may occur in the foreseeable future.”*

### **Prudential Sourcebook for Insurers (INSPRU)**

- 2.8. INSPRU 1.1.28 R states:

*“In addition to complying with INSPRU 1.1.27 R, a realistic basis life firm must also ensure that the realistic value of assets for each of its with-profits funds is at least equal to the realistic value of liabilities of that fund.”*

### **Enforcement Guide**

- 2.9. Enforcement Guide 2.25 (3) states:

*“Guidance and supporting materials are, however, potentially relevant to an enforcement case and a decision maker may take them into account in considering the matter. Examples of the ways in which the FSA may seek to use guidance and supporting materials in an enforcement context include: (3) to inform a view of the overall seriousness of the breaches e.g. the decision maker could decide that the breach warranted a higher penalty in circumstances where the FSA had written to chief executives in the sector in question to reiterate the importance of ensuring a particular aspect of its business complied with relevant regulatory standards.”*

### **The FSA Glossary**

The FSA Glossary states that a “*with-profits committee*” is:

*“a committee of the governing body, including non-executive members of the governing body and possibly some external non-directors with appropriate skills and experience.”*

### 3. EXTRACTS FROM “DEAR CEO” LETTER

#### 3.1. The “Dear CEO” Letter states:

##### ***“Governance arrangements for with-profits funds (open and closed)”***

*The purpose of our guidance is to secure an appropriate degree of protection for with-profits policyholders and to promote confidence among such policyholders. Consistent with the Senior Management Arrangements, Systems and Controls (SYSC) part of our Handbook (specifically SYSC 3.2.6R), our approach is that governance arrangements should, “be appropriate to the scale and complexity of a firm’s with-profits business” and should “involve some independent judgement in the assessment of compliance with PPFM [the Principles and Practices of Financial Management] and how any competing or conflicting rights and interests of policyholders and, if applicable, shareholders have been addressed” (COB 6.11.5G)<sup>1</sup>. We accept that independent judgement can be provided in different ways (and that the effectiveness of the arrangements depends on both the quality of challenge and the skills/ experience of the independent input). These may include, but are not confined to, establishing a With-Profits Committee (WPC) or asking an independent person or non-executive member of the Board to perform this function (COB 6.11.6G). We also acknowledge that the Board could take a different view to any independent input it receives – the Board has ultimate responsibility for the proper conduct of the firm’s with-profits business.*

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***Scope of WPC/independent reviewer.*** *We found that some firms’ arrangements aim to comply with our guidance (i.e. monitoring compliance with the PPFM) rather than thinking about the broader outcome that the governance arrangements are intended to achieve in terms of Principle 6 (treating customers fairly) and Principle 8 (managing conflicts of interest). As a result, in some firms the range of issues referred is more limited than we would expect it to be. Senior management need to ensure that firms’ with-profits governance arrangements are consulted on all significant issues affecting with-profits policyholders’ interests (e.g. changes to investment strategy, charges and bonuses). They should also be able to provide an independent challenge in the assessment of how any conflicts of interest between policyholders and, if applicable, shareholders have been addressed.*

***Timeliness of information and access to the Board.*** *We found several examples where the WPC/independent reviewer was told of significant decisions after they had already been made by the Board. In other instances there was not sufficient time given for the WPC/independent reviewer to review, challenge and report back to the Board and, in some instances there was no audit trail of the challenge process.*

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<sup>1</sup> COB 6.11.5G and COB 6.11.6G ceased to apply from 31 October 2007. The provisions contained in COB 6.11.5G and COB 6.11.6G were included within chapter 20 of COBS which came into force on 1 November 2007.

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*We expect senior management of firms that operate with-profits funds (whether large or small) to review how they have implemented the Principles for Businesses (and our SYSC requirements) in their governance arrangement and oversight of closed funds in run-off. This will include reference to the provisions set out in COB 6.11 and COB 6.12, where relevant. You should consider whether your arrangements achieve the purpose intended, specifically if you are delivering the outcome of fair treatment of with-profits policyholders. Where this review reveals shortcomings, we expect firms to take prompt action to remedy them.*

*We will continue, as part of supervisory work, to assess firms' compliance with our relevant Principles, rules and guidance in relation to with-profits governance and run-off plans. And we will take supervisory or enforcement action, where appropriate, in cases where we find that customers are not being treated fairly."*