Financial Services Authority

FINAL NOTICE

To: **JOHN HUBERT WHITCOMBE**

Of: **Ivanhoe House**
The Green
Wethersfield
Braintree
Essex CM7 4BS

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 an underwriter writing 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 claims against you for dishonest breach of fiduciary duty and fraudulent misrepresentation succeeded. 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 notice relates. Under those 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 Order 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 are taken from the judgment of Mr Justice Thomas cited above. The following are 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 paragraphs 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).

1.9 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.

1.10 You were a director of EIU and were named as an underwriter under the binding authority. 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).

1.11 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.

1.12 Mr Justice Thomas found in favour of SD on all material grounds. 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

The November 1996 business plan

1.13 You sent a draft business plan to an employee of SD, Mr Broad, as part of the negotiation process for the grant of the binding authority in your favour. You were assisted in drafting the second draft of that business plan, which was sent to SD on 26 November 1996. Neither draft of the business plan explained that the intention was for gross loss making business to be written under the binder, or that an employee of EIU (hereinafter referred to as "the EIU employee") would act as your underwriter in relation to the binder.

1.14 It was argued in EIU and SCB's defence that Mr Broad had authorised the writing of gross loss making business under the binder. However, Mr Justice Thomas found that "*I am sure that Mr Broad was never told and never understood that gross loss making business was to be written: he never authorised the writing of an account of gross loss making business to be written on the backs of reinsurers*" (Part I paragraph 721).

1.15 Mr Justice Thomas was "*sure that there was a common understanding between SCB and Mr Whitcombe and* [the EIU employee] *in relation to EIC that SCB would offer them their book of WC carve out business and that* [the EIU employee] *would write it… there were meetings between SBC and SIU before the binder was signed during which I am sure that that was re-affirmed*" (Part I paragraph 727). He was also "*sure that, for the reasons given at paragraphs 733 and following, the plan was deliberately drafted to conceal the true intent to write gross loss making business*" (Part I paragraph 728).

1.16 Mr Justice Thomas further held that "*the omission of* [the EIU employee's] *name from the plans was a deliberate act on the part of Mr Whitcombe;* [the EIU employee] *had been mentioned in the earlier proposals and the only credible explanation was that Mr Whitcombe removed the reference to him as he was selling the business to Mr Broad as business that Mr Whitcombe, an experienced Lloyd's underwriter, could be trusted to write. Any mention of* [the EIU employee] *as the underwriter may have given rise to questions*" (Part I paragraph 731).

1.17 Mr Justice Thomas stated that he was "*sure that the business plan contained misrepresentations which I am sure Mr Whitcombe and* [the EIU employee] *knew to be untrue and which were intended to conceal the true nature of the account to be underwritten by* [the EIU employee], *namely that it was to comprise a significant amount of gross loss making WC carve out business that was to be written on the backs of reinsurers. It was not a document innocently prepared in a way that could*

have been better expressed, but a carefully crafted document which was intended to deceive any reader and to disguise the true nature of what was to be done" (Part I paragraph 733).

1.18 Mr Justice Thomas held that "*Mr Whitcombe plainly knew it was dishonest to say that EIU had the experience to write the business without saying anything about his own lack of experience and about what* [the EIU employee] *was to do*" (Part I paragraph 734).

1.19 In conclusion, Mr Justice Thomas was "*sure that Mr Whitcombe and* [the EIU employee] *had deceived Mr Broad into giving them a binder which they had intended to use for a purpose that they knew he had never authorised*" (Part I paragraph 737).

1.20 The second draft of the business plan stated that you had "*started two syndicates, 456 and 1053, neither of which ever made a loss whilst under* [your] *contro*l" (Part I paragraph 657). Mr Justice Thomas held: "*I am sure that the statement that the syndicates had not made a loss was untrue and must have been known by Mr Whitcombe to be untrue."* (Part I paragraph 659).

The business written under the binding authority

1.21 The EIU employee wrote a total of 112 contracts (grouped together as 35 programmes of reinsurance) placed with him by SCB under the binding authority granted by Sphere Drake.

1.22 Mr Justice Thomas found (at Part I paragraph 795) that overall, you never "*properly understood the business that* [the EIU employee] *was accepting"* under the binder. You *"essentially left the business to* [the EIU employee] *and* [your] *confirmation was purely nominal as* [you were] *not in a position to make any assessment of the individual contracts*". Indeed, he found that you "*signed a whole number of confirmation sheets in blank to save time*" (Part I paragraph 797) and that the EIU employee "*just got on with it*" (Part I paragraph 796).

1.23 Mr Justice Thomas found that you had *"acted dishonestly in going along with* [the EIU employee's] *acceptance of business which* [you] *did not really understand and which* [you] *knew Mr Broad had not approved*" (Part I paragraph 865).

The initial programmes

1.24 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).

1.25 Mr Justice Thomas said that "*if Mr Whitcombe had thought about that or had tried to understand the business he was confirming at that time, he would have understood that he was making SD the funnel for the losses as no other conclusion was possible*" (Part I paragraph 841).

The Christmas Eve/New Year's Eve 1997 programmes

1.26 In relation to the 12 programmes written by the EIU employee under the SD binder on Christmas Eve 1997, Mr Justice Thomas found that the EIU employee "*did not consider any risk properly (which he had to do)*" (Part I paragraph 1178). The EIU employee then went to see you and went through the risks with you: Mr Justice Thomas found that you had "*no real understanding of the programmes written*" by the EIU employee (Part I paragraphs 1179 and 1180).

1.27 Mr Justice Thomas found that "*although Mr Whitcombe understood very little of the business, he knew that EIU had been forced into writing these programmes, that Mr Broad knew nothing of the circumstances and the fact that gross loss making business was being written against reinsurers…Mr Broad was not told about the creation of the spiral, although it was highly material he should have been… the dishonesty of Mr Whitcombe's conduct is also beyond doubt*" (Part I paragraph 1247(iv)).

The 1998 programmes

1.28 The EIU employee wrote a further 7 programmes presented by SCB under the binder in 1998. This was despite EIU's knowledge that SCB had been implicated in allegations brought by Transamerica (a reinsurer of Lloyd's Syndicate 103) involving the artificial creation of a PA spiral (see Part I paragraphs 1331 and following). Mr Justice Thomas found that EIU and SCB must have been "very *well aware of the allegations made in respect of Syndicate 103 and of the very serious consequences that would follow to anyone else writing such business"* (Part I paragraph 1339) but continued to deal with SCB nonetheless.

1.29 In relation to the programmes written in early 1998, Mr Justice Thomas found that "*EIU and* [the EIU employee] *in particular had acted dishonestly in accepting each of these seven programmes… SCB dishonestly assisted them*" (Part I paragraph 1537).

Misleading underwriting reports submitted to SD

1.30 As SD's agent under the binding authority granted by SD, it was EIU's responsibility periodically to submit underwriting reports to inform SD about the business that EIU had been writing on SD's behalf.

1.31 EIU's first underwriting report to SD was delivered on 17 November 1997. Mr Justice Thomas held that it was "*a document designed and carefully crafted to deceive anyone who read it who did not know what EIU had actually done... (i) The major programmes written were gross loss making business written on the backs of reinsurers. It was dishonest not to make that clear in the report. (ii) The figures were designed to mislead; it was dishonest not to have made significant provisions for the inevitable and substantial losses that must have been incurred but not yet reported… (iii) it was dishonest to say that a profit was anticipated without stating that it was dependant on reinsurance which was not yet in place; without it they knew that the losses would be catastrophic; (iv) it was dishonest to have omitted any mention of the cessation of business*" (Part I paragraph 1107).

1.32 Mr Justice Thomas also held that the part of the underwriting report that dealt with

1998 was "*designed to deceive*": in particular there was no mention of the intention to create a spiral (Part I paragraph 1111).

1.33 You and the EIU employee submitted a second misleading underwriting report to Mr Broad on 11 February 1998. Mr Justice Thomas concluded that this report was "*designed to deceive anyone who read it*": for example, there was no "direct" business as the term is normally used; it was dishonest to describe gross loss making business as good quality business; in any event the report did not make clear that the business was gross loss making; the report dishonestly stated that premium income was $12 million, in order to keep within the agreed limit; and it was dishonest in that there was no mention of the spiral created for the 1997 account. The report also referred to the proposed 1998 account, but did not describe what had already been written for 1998. (see Part I paragraphs 1299 and following).

1.34 The third underwriting report, presented in May 1998, stated that "*the account itself is developing as expected, at this stage however it would be unwise to predict anything other than a satisfactory outcome"* (Part 1, paragraph 1356). In relation to the business written in 1998, it stated that SCB "*have shown and continue to show a good spread of business*" (Part 1, paragraph 1358). Mr Justice Thomas concluded that this report was "*another document that was produced by EIU with a design to deceive, just as the two earlier reports had done*" (Part I paragraph 1360). He further stated that "*in the light of the cash flow problems and of the avoidance at Syndicate 103 of which* [the EIU employee] *and Mr Whitcombe were well aware, their continued suppression of the truth was even more inexcusable*" (Part 1, paragraph 1360).

Further examples of misleading/deceptive conduct

1.35 On 23 December 1997 you wrote to Mr Broad, referring to the negotiations with SCB for comprehensive reinsurance and attaching the quotes. The letter stated that the quotes were "*supported in full by various A rated companies for which [SCB] require a firm order*" (Part 1, paragraph 1166) and stated that an increase in EIU's facility to £6 million gross premium limit would be required. It also stated, "*this business is predominantly Direct emanating entirely from their Occupational Accident account as described in our 1997 business proposal*" (Part 1, paragraph 1166). Mr Justice Thomas found that "*the letter was grossly misleading and dishonest*" (Part I paragraph 1167) in various respects, which Mr Justice Thomas lists in the paragraph cited.

1.36 In February 1998, Mr Broad heard a market rumour that you "*had written a substantial retrocessional account with significant losses*" and that the business he wrote was "*a load of rubbish… on a large scale*" (Part I paragraph 1313). You denied this. Mr Justice Thomas found that you "*acted dishonestly in telling Mr Broad that all the allegations were a load of nonsense and in not telling him that they were writing a retro account, when that had been one of the main allegations*" (Part I paragraph 1315).

1.37 On 29 May 1998, you sent to Mr Broad details of stop loss reinsurances which were to be placed to protect the retentions. The letter set out four layers each for 1997 and 1998. In fact, only one layer had been placed for each year (see Part I paragraphs 1363 and following). Mr Justice Thomas held that the EIU employee "*and Mr Whitcombe knew that the stop loss reinsurances had not been placed*" and that "*their*

statement that it had been was known to be untrue" and was "*designed to deceive Mr Broad"* in "*a further attempt to reassure him of a prudent and careful approach, whilst concealing the fact that they were writing gross loss making business against reinsurers*" (Part I paragraphs 1363 and 1366).

1.38 In September 1998, SCB and EIU agreed to an endorsement that permitted a very substantial amount of new business to be ceded to Programme 26, one of the programmes written on Christmas Eve 1997 (Part I paragraph 1685 and following). In doing so, they acted in breach of a moratorium that they had agreed with SD on 28 July 1998, under which they had agreed to write no further business under the binder.

The key conclusions of Mr Justice Thomas

1.39 Mr Justice Thomas found that a claim for dishonest breach of fiduciary duty succeeded against you (Part I paragraph 1863). He also found against you for fraudulent misrepresentation. He stated that you had given untruthful evidence during the trial (Part I paragraph 1862(xiii)).

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.