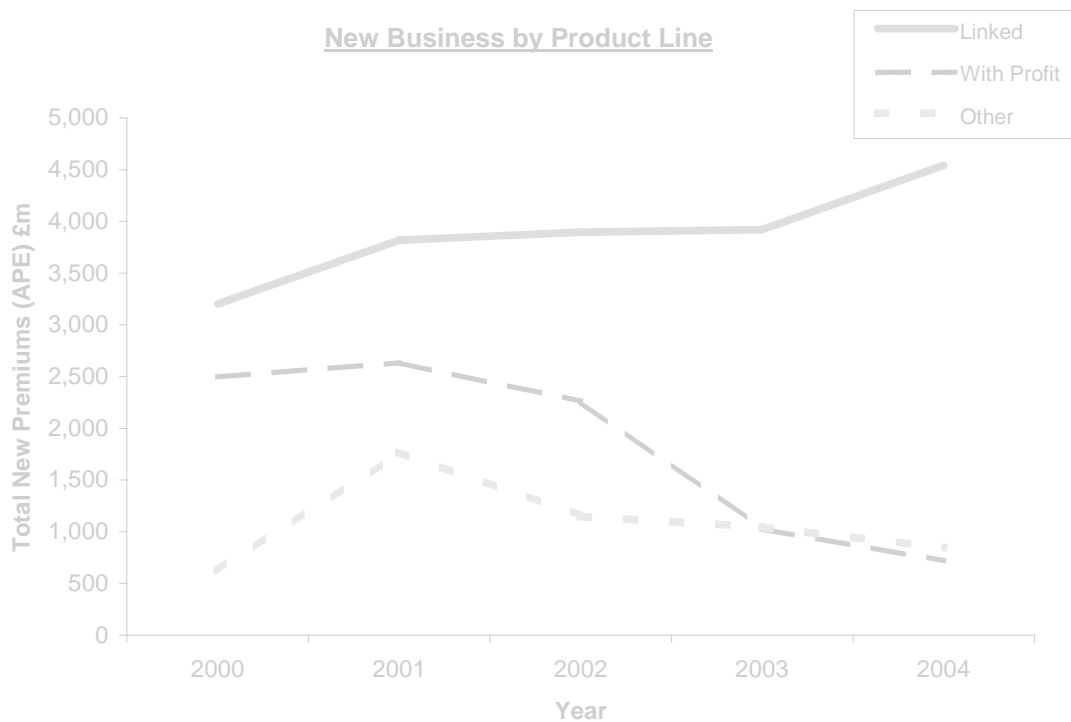




ASSOCIATION OF BRITISH INSURERS

A GUIDE OF GOOD PRACTICE FOR UNIT LINKED FUNDS



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1. Foreword

1.0.1 This Guide establishes standards that the ABI believes all companies managing unit linked funds should aspire to and work toward. The Guide sets out requirements in the following areas :

- Governance
- Documenting the scope and exercise of discretion
- Disclosure
- Pricing
- Valuation
- Transaction processing
- Box management
- Rounding
- Error correction

1.0.2 It is acknowledged that existing practices may not meet all of these standards and that in some cases products sold in the past may not ever fully meet these good practice guidelines owing to the materiality of the issues, the disproportionate costs, or contractual constraints.

1.0.3 Nevertheless, where firms do not meet these guidelines, it will be incumbent on them to explain the reasons for this to their supervisors.

1.0.4 Following adoption of this Guide by the ABI, firms will need to review their existing policies and processes and make adjustments where appropriate.

1.0.5 By 31 December 2006 firms should have undertaken a high level gap analysis against the standards set out in this Guide and begun making progress towards the changes needed to meet these standards. In some cases significant changes to systems and processes may be required which will have a longer timeframe for completion. However, a clear plan should be in place by end-2006 to achieve the necessary changes.

1.1 Introduction

- 1.1.1 This document is intended to provide a 'Guide of Good Practice' for insurance companies operating unit linked funds.
- 1.1.2 It has been prepared recognising that there is not currently a detailed set of rule requirements placed on Unit Linked fund managers. Instead, the FSA set out a framework of principles for business which senior management must apply and interpret, coupled with some specific requirements in particular areas, such as permitted links for investments.
- 1.1.3 The guiding principle throughout this document is that firms must act in accordance with the concept of Treating Customers Fairly (TCF) as set out by the FSA in a number of publications¹ and in their Principles for Business, which form part of the FSA Handbook. TCF incorporates a number of elements including 'Policyholders' Reasonable Expectations' (PRE) but is a much broader concept. Where appropriate, we have also drawn upon the ABI's own work in our *Customer Impact* scheme².
- 1.1.4 This Guide has been prepared by a working group of the Association of British Insurers (ABI) to provide more specific guidance to firms looking to understand what TCF means in the context of unit linked fund governance. The FSA has also indicated that it will take account of the standards set out in this Guide in their supervision of unit linked life offices.
- 1.1.5 It is recognised that some funds will have either a significant, or exclusively institutional investor base, which may influence how the standards in this document are applied. Wholesale fund parameters will differ in some areas and in these cases firms will rightly depart from the standards indicated as appropriate to retail customers.
- 1.1.6 There is also a distinction to be drawn between closed funds, which have a finite lifetime and revenue stream, and those funds continuing to accept new customers. In the former case, complex or expensive systems changes may not be financially viable and an appropriate balance will need to be struck between raising standards and sustaining the business in run off.
- 1.1.7 However, even for closed funds it is likely that there will be additional premiums paid, or switches or surrenders of policies beyond 31 December 2006. Accordingly, firms operating closed funds should still review their existing practices and work towards the standards in this Guide unless such change would have a disproportionate cost or the changes would be immaterial to their policyholders.

¹ See FSA's original discussion Paper, June 2001 : <http://www.fsa.gov.uk/pubs/discussion/dp7.pdf> and their recent consumer research paper June 2005 : <http://www.fsa.gov.uk/pubs/consumer-research/crpr38.pdf>

² This is initiative sets out standards to improve customer service, building on the original 'Raising Standards' scheme

1.2 Status of the Guide and Implementation

- 1.2.1 This Guide was endorsed as a statement of Good Practice by the ABI Board on (17 May 2006). The ABI consulted with the FSA in developing the standards in this document, however this Guide does not constitute guidance from the FSA. In the event of conflict between the Guide and the FSA Handbook, the FSA's Handbook text prevails. Ultimately, interpretation of the law is a matter for the courts.
- 1.2.2 However, this Guide does establish standards that the ABI believes all companies selling unit linked policies should meet within a reasonable period, taking into account the results of their gap analysis and their financial and other circumstances³. The FSA supports this initiative, which will inform its approach to the supervision of unit linked life offices.
- 1.2.3 It is acknowledged that in some cases firms may adopt a policy or approach at variance with that set down in the Guide. Where this occurs, a firm should be able to explain why they are adopting a different approach and to demonstrate how this approach is at least as effective in securing TCF. Alternatively, if they cannot meet the standard set out in the Guide, (or an equivalent) they should be able to explain why such a standard would not be appropriate to their circumstances – for instance on grounds of materiality or disproportionate cost.
- 1.2.4 The ABI have prepared this Guide of Good Practice to assist firms in meeting the FSA's regulatory requirements as set out in their high-level 'Principles for Business'. It is intended to assist both firms and supervisors in interpreting these principles by providing a more detailed framework of good practice standards.
- 1.2.5 The FSA recognise the potential of the Guide to assist firms in meeting their regulatory obligations and have taken account of its anticipated implementation when considering their priorities for regulatory reform going forward. They will also take into account firms' compliance with the standards in this Guide in their supervision of unit linked life offices.

Implementation

- 1.2.6 Subject to the constraints outlined, we would expect firms to have reviewed their own policies and begun implementation of the necessary changes to meet these standards by 31 December 2006. However, we do not expect firms to make retrospective adjustments to transactions already completed⁴.

³ By 31 December 2006 a plan should be developed by the firm setting out the measures it intends to adopt and the proposed timetable, taking account of the findings of the gap analysis, including the economic factors and any other circumstances affecting the nature and timing of the proposed changes.

⁴ We do not expect firms to re-price past transactions according to these new standards, but this should not preclude the correction of errors where existing contracts were incorrectly priced under the standards prevailing at the time the transaction was undertaken.

1.2.7 It is acknowledged that existing practice in firms will not meet all of these standards and that in some cases products sold in the past may never fully meet the requirements set out in these guidelines for new business owing to contractual constraints, disproportionate costs or materiality considerations.

1.2.8 In other areas, where substantial investment in IT or systems change is required this may also entail a longer timescale, but a clear plan and timescale for implementation should be established by the firm.

Review and update of the Guide

1.2.9 This Guide represents a new initiative by the industry, which for the first time provides a framework to record good practice and will help firms to interpret the application of the 'Treating Customers Fairly' principle in the context of unit linked life products.

1.2.10 This is intended to be a living document, more flexible than a rule-book based solution and able to adapt to recognise emerging thinking and good practice. Accordingly we would expect a periodic review of the content and standards in the Guide to ensure that they remained appropriate and up to date, with any new material added where this was considered to be of benefit.

1.2.11 The focus of the work to date has been on pricing and related issues of governance and control. In the future it may be appropriate to extend the scope of the guidance.

1.2.12 Specifically, following the expected completion of the gap analysis exercise by the end of 2006, it may be appropriate to update the Guide in the light of these findings. This would draw upon both the experience of firms in beginning to apply the standards and the FSA in using the Guide to inform its approach to the supervision of unit linked life companies.

2. Fund Governance

2.1.1 Insurance companies operating in the unit linked field will generally have a number of funds in existence. Their structure and policy conditions will vary according to the legacy of their creation and with a number of mergers and consolidations in the sector, differences will exist between funds even with the same insurer.

2.1.2 However, the governance structure will typically include :

The Board

2.1.3 *The Board carries ultimate responsibility for the oversight and management of the fund.*

A General Management Committee

2.1.4 *A management committee may be appointed by the Board and delegated to perform a day-to-day management role. This may include monitoring and management of the risk management process*

A Pricing and Actuarial Committee / Function

2.1.5 *A committee (or an individual) may be appointed by the Board with delegated responsibility to oversee the fund's pricing arrangements, ensuring targets for accuracy are met, and fairness to customer in the application of pricing policies.*

The Actuarial Function holder

2.1.6 *The actuarial function holder must fulfil a range of responsibilities set out in the FSA Handbook⁵ to advise the Board on the management of the fund, including any risks run by the fund in meeting their liabilities, issues of capital adequacy, etc.*

Internal audit / compliance

2.1.7 *Internal audit and compliance provide an essential function in defining and monitoring appropriate standards for the operation of the fund, reporting these findings ultimately to the Board.*

2.1.8 The Board may choose to out-source certain functions to third parties. Where this is the case, the Board must ensure that they have appropriate systems and controls in place, including regular and reliable management information, to ensure that they can fulfil their responsibilities to policyholders. Further specific requirements in this area are set out in the FSA Handbook.⁶

⁵ See SUP 4.3

⁶ See SYSC 3A.9

2.1.9 Whilst this Guide⁷ provides a high-level framework, the individual policy conditions should define in more detail the boundaries within which a company has agreed to operate its unit-linked funds. This should cover:

- How and when value is assigned to each asset.
- Deductions that can be made from the funds, including charges and allowance for taxes and how they are calculated.
- The basis on which the company can create or cancel units in a fund.
- The calculation of fund prices, including allowance for selling and buying costs.
- The basis of transacting with policyholders.

2.1.10 Where this information has not been set out in individual policy conditions, then firms must ensure that they make such information readily available to their customers⁸. Firms should ensure that in addition to any summarised customer information, further explanation and more detailed information is clearly sign-posted and provided on request.

2.1.11 Taken together, all the information provided (or made available) to customers should enable them to understand how the firm operates the fund and manages their investments. It will also provide the FSA with a clear statement of the standards applied to the fund, offering a criterion against which to review the fund's operation.

⁷ In conjunction with the relevant rules and principles for business contained within the FSA Handbook

⁸ The principal terms and features of the policy should appear either in policy conditions or some other policy document provided to new retail customers. For existing customers, where such information has never been provided, the firm should consider how best to draw this information to attention, for instance by publication on the firm's website and/or inclusion of a reference in an annual statement or other customer mailing, with an offer to provide details on request.

3. Use of Discretion in Managing the Fund

- 3.1.1 Where discretion is exercised in the management of the fund, it is very important to ensure that the firm treats its customers fairly.
- 3.1.2 Where possible, and as set out in this guide, funds should be operated according to published criteria and standards. Specifically, the scope of the firm's discretion in managing the fund and the limits to that discretion should be documented and disclosed to policyholders and other relevant parties⁹.
- 3.1.3 This codification provides a clear point of reference against which to review any decisions taken, helping to provide clarity and certainty for all parties.
- 3.1.4 The scope of discretion should be confirmed annually with a more significant review every three to five years, or upon a significant change to the fund or the investor base.
- 3.1.5 Robust and effective reporting structures should be in place to allow the Board¹⁰ to monitor the exercise of this discretion on an on-going basis, to ensure that policyholder interests are safeguarded.
- 3.1.6 Subject to the terms of the original policy conditions, areas where discretion may be applied include :
- Launching funds and seeding with shareholder capital
 - Allowing for dealing costs
 - Unit Price rounding¹¹
 - Application of annual management charges and any ability to alter the definition or level of the charge.
 - Tax (e.g. how actual charges or credits for tax are calculated, when they are taken from fund or credited to fund, how deferred tax provisions are calculated)
 - Introducing charges for new or unforeseen types of expense which may not be described or covered under existing policy terms
 - Criteria for moving funds between bid and offer bases¹²
 - Merging funds
 - Internal deals between two unit linked funds
 - Ability to defer switches / surrenders (e.g. in adverse market conditions)
 - Ability to defer transactions by customers seeking to exploit market timing opportunities
 - Ability to close a fund to new business or switches in

⁹ For general policyholder communications a significantly abridged and simplified description of the scope and effect of the use of discretion would normally be provided. A full, technical account of these powers should then be made available to the regulator and others where appropriate.

¹⁰ Either directly or through a delegated body

¹¹ See later section on rounding

¹² Which has potential to dilute or concentrate the fund

- Basis for valuing assets – especially where market prices do not exist
- Determining, if applicable, distribution rates for income
- Choice of pricing point
- Frequency and time of pricing
- Addressing breaches of policy conditions or other customer commitments and dispute resolution

4. Operating Standards

- 4.0.1 Openness and transparency are fundamental concepts that underpin the principle of Treating Customers Fairly. The standards set out in this Guide strongly support this open and transparent approach. Wherever possible processes and decisions should be documented by the firm with relevant information made available both to the regulator and to policyholders, according to their respective needs and requirements.
- 4.0.2 However, this should not imply large amounts of new, unsolicited, printed material being sent to every policyholder. Instead, it is anticipated firms should adopt a combination of measures to meet the requirements set out in this Guide, to increase the scope and quality of information available to policyholders. Some of this information may go into new and existing customer literature, some may be published on a website or in other mass-media formats and some information is likely to be of interest only to the regulator, intermediaries and large institutional investors.
- 4.0.3 Firms must ensure that they make it easy for customers to access information relevant to their investment decisions. Customer literature must distil those key elements which are essential to enable retail investors to make effective and informed choices, whilst more detailed information should be clearly sign-posted and made available on request¹³.
- 4.0.4 In short, it is about empowering ordinary policyholders with concise and relevant information, not swamping them with a mass of technical, abstract disclosures that they are unlikely to need, read or ever understand.

¹³ This is an approach that the FSA are particularly keen to promote and firms' success in meeting this requirement will inform the FSA's view of the need to take further action in this area, in particular to consider formal new rules and guidance on disclosure for unit linked funds.

4.1 Pricing Issues – Overview

4.1.1 Unit prices should be calculated in a fair and transparent manner, which means :

- 1) Cross-subsidy among policyholders or individual funds should be avoided as far as reasonably possible.
- 2) The pricing mechanism should not be used as a deliberate means of extracting value from the fund or from policyholders¹⁴.

4.1.2 In particular, unit prices will be calculated so as to treat policyholders fairly, in accordance with policy provisions, legislation, insurance regulations, and FSA rules and guidance¹⁵ where appropriate.

4.1.3 Expenses, income and taxation should be recognised appropriately in the price, being accrued in a timely and accurate fashion so that the unit price properly reflects the value of the underlying assets.

¹⁴ This is not intended to cover incidental or unintentional flows which may arise on a limited scale, nor prevent the proper application of disclosed management charges and fees

¹⁵ The CIS Sourcebook provides useful context in this area – see in particular CIS Ch.7 Annex 1G

4.2 Pricing models

4.2.1 Whilst there are many possible permutations in the method for calculating prices, at its simplest there are two different approaches¹⁶:

- 1) Forward pricing. This involves calculating the price at which the transaction is undertaken after the deal is done, so as to establish the 'true' value of the units at the time of purchase or disposal.
- 2) Historic pricing. Transactions are undertaken on the basis of a known, quoted price at the time the deal is done, based on an existing (i.e. historic) valuation of the assets in the fund.

4.2.2 Each approach has advantages and disadvantages. The firm must carefully consider the effect of its chosen pricing model on its customers, particularly retail customers, who are unlikely to have the knowledge or expertise to question the firm on its approach and so must rely on the firm to safeguard their interests.

4.2.3 A historic pricing model has the attraction of allowing customers to deal at a known price, rather than having to wait until after the deal is done to establish the exact terms of settlement (i.e. the price at which the units were bought or sold). The administration of historic pricing may also prove to be simpler, easier and cheaper, particularly where a substantial proportion of transactions are pre-determined regular investments¹⁷.

4.2.4 Whereas, in its purest form, a 'forward pricing' approach should ensure that the price at which a customer's order is transacted precisely matches the value of the underlying investments backing those units. This eliminates the risk of any potential mis-match between the dealing price and the value of the underlying investments. Where such a mis-match does occur, this can be exploited by sophisticated and well-informed customers to the disadvantage of other investors in the fund¹⁸.

4.2.5 Where the firm itself is dealing with the fund, rather than with customers, (for example for internal reconciliation) this would usually be on a forward-price basis and should not normally be based on historic prices.

¹⁶ Whilst this is a simplification, the actual pricing model used by the firm will normally exhibit characteristics of either 'forward pricing' or 'historic pricing'.

¹⁷ The potential distortion between historic prices and current underlying asset value may in practice be largely eliminated where the firm can anticipate and synchronise planned customer orders with unit creation / cancellation.

¹⁸ A sophisticated investor may use knowledge of a significant movement in the value of the fund's underlying assets to purchase or dispose of units in the fund at the historic price, based on earlier asset valuation. Accordingly, this sophisticated investor accrues a risk-free profit to himself at the cost of the fund's underlying investors, or to the shareholders of the firm managing the fund where a box or other mechanism is used to by the firm to protect the fund from this risk.

4.3 Pricing Frequency and unit transaction timing

4.3.1 The timing of unit transactions such as allocation to policyholders, creation and cancellation of units will be determined according to events such as the receipt of policyholder instructions. The following objectives should be taken into account when determining pricing frequency and unit transaction timing :

- Avoiding any losses to policyholders through market timing and other 'strategic dealing activity'.
- Maintaining, within defined tolerances, appropriate levels of liquidity in the fund to avoid any significant, unintended gearing effects.
- Ensuring that funds designed to track the performance of an underlying asset, for example an OEIC, do so within defined tolerances avoiding the risk of any significant distortion or deviation.
- Avoiding any material loss to the fund or policyholders by ensuring a good match between net policyholder unit transactions and the related asset purchase or disposal¹⁹.
- Avoiding any material loss to the fund or policyholders by ensuring there is no undue delay between receipt of a trading instruction from a policyholder and the resulting unit transaction.

4.3.2 To help firms apply this approach and meet the overall requirements of TCF, the following standards are recommended as good practice.²⁰

Pricing Frequency

4.3.3 Funds will typically be valued and priced on each working day. Where the price is updated at a fixed time during the working day, or pricing is scheduled to occur less frequently than once per day, this will be disclosed to policyholders²¹.

Pricing basis : switching between bid and offer pricing

4.3.4 The firm should keep the pricing basis of the fund under regular review, so as to avoid any significant dilution where the net flow of investment (either into or out of the fund) changes. It may be appropriate to switch the pricing basis quite frequently where material changes in the flow of

¹⁹ In some cases, for example property funds, asset acquisition or disposal may lag behind buy / sell orders in the fund, resulting in the potential for excess liquidity or excess exposure. Unless precluded under existing policy conditions, firms should consider delaying significant policyholder transactions where these cannot be synchronised with purchase or sale of the necessary assets. In extreme cases, new business into that fund may need to be restricted.

²⁰ These standards represent good practice, but firms may in some cases apply an alternative approach – for instance to meet existing policy conditions. The firm should be able to demonstrate that their own approach can meet the same standards of TCF

²¹ This information may be set out in the policy conditions or otherwise made publicly available

funds occurs, in order to protect the interests of continuing policyholders.

- 4.3.5 Where the fund uses a single price and applies a dilution levy, a similar principle applies. The purpose should be to ensure broad neutrality between new and continuing policyholders, so as to avoid any material concentration or dilution of the fund arising from customer transactions.

Historic pricing

- 4.3.6 As discussed above, any pricing model which relies on past data to determine the unit price of the fund will carry the risk of mis-match between the quoted price and the underlying value of the units.
- 4.3.7 Whilst fully prospective pricing and valuation of assets would be unrealistic in most cases, given the delays to settlement this could imply²², firms should seek to ensure that the price and valuation information used is as up-to-date as possible.
- 4.3.8 Where a firm uses a historic price model and identifies a significant movement in asset values²³ based on interim price information or proxy data since the last pricing point, the firm should consider whether, in the interests of its customers, it should continue to execute orders at the historic price, or move to update the price / unit valuation in advance of the next scheduled pricing point.

Market timing

- 4.3.9 Where the firm's pricing model relies to any extent on historic prices or valuations, then certain additional safeguards should be considered, both to protect against strategic dealing activity and to ensure fairness to new and existing policyholders²⁴.

- 4.3.10 Responses may include :

- Deferring execution of deals
- Temporarily suspending the right to deal for customers believed to be engaged in market timing activity
- Moving to a 'Fair Value' model of pricing
- Moving to a forward pricing model

- 4.3.11 The extent of any response needed will depend upon movements in the underlying asset markets and the pattern of customer transactions with the fund.

²² For unquoted assets such as property, formal valuation may occur relatively infrequently. Even for quoted securities there may be a compounding of delays where one fund invests in another fund – especially in overseas markets.

²³ The firm would typically define a specific review threshold, to reflect the considerations set out in this section on pricing frequency and unit transaction timing.

²⁴ In some instances, existing policy conditions would limit the firm's ability to take such action

Transaction processing

4.3.12 The firm should ensure that transactions are processed and settled in a timely manner. Where delays do occur the firm will make good any loss suffered by the policyholder or the fund as a consequence of the delay. Large, unplanned backlogs not only impede efficient and effective administration, compromising customer service standards, they can also result in unintended additional risks for the firm. Wherever possible such backlogs should be avoided but where, exceptionally, they do occur, every effort should be made to address the backlog and return to normal operating conditions as quickly as possible.

Box Management

4.3.13 It is acknowledged that maintaining a Box may be helpful in providing an interface between customers' transactions, buying and selling units on an almost instant basis, with the subsequent underlying asset transactions in the fund. It allows the two processes to be de-coupled to a limited extent so that the fund manager has time to adjust the underlying portfolio to match the overall unit investment base²⁵.

4.3.14 Shareholders (or owners of the business) put up risk capital to cover these units (or liabilities in the event of a negative box) and can expect to earn a return. However, in accordance with the principle of Treating Customers Fairly, the firm should not exploit the information at its disposal to profit²⁶ from the fund through strategic management of the box.

4.3.15 In the absence of proper safeguards firms can have a material impact on unit prices as a result of their actions in creating/cancelling units, in transacting switches across funds and in their management of the box. In order to safeguard policyholders, the following considerations should apply²⁷:

- The company must hold assets whose value matches the total unit liability as closely as possible²⁸.
- The firm should set clear limits for the operation of the box with close monitoring and regular reconciliation to the firm's administrative systems.
- Any deviation from the box limits should be recorded and justified.

²⁵ A 'box' is just one means of managing customer transactions with underlying asset movements in the fund. There should be no presumption that a box is necessary or required to secure fair dealing for customers.

²⁶ It is acknowledged that some firms hold their own reserves as units in the fund. This can clearly be distinguished from short-term strategic 'arbitrage trading' by the firm.

²⁷ These considerations are not intended to prevent cross holdings by one unit linked fund in another, or significant holdings of units by with-profits funds

²⁸ This is necessary to meet the matching requirements for policyholder liabilities set out in the EU Consolidated Life Directive and see also the FSA Handbook: PRU 4.2.57R

- Unit creations / cancellations by the box manager, and inter-fund cross-holding transactions should be carried out on a basis that will meet TCF requirements.

Cash transaction timing

4.3.16 Firms should ensure that the timing of cash transactions (e.g. applying management charges and tax payments) between the fund and the company do not give rise to an undue gearing effect on policyholder returns.

4.4 Valuations

4.4.1 Where possible assets will be valued at current, recognised and independently assessed prices. Any reliance upon 'stale' prices significantly increases the risk of strategic dealing activity (market timing) and may discriminate unfairly against either new or existing policyholders.

4.4.2 Prices for securities should be derived from recognised sources including Bloomberg, Reuters, Ex-share, IBOX, Bridge, FT Interactive, stockbrokers or other appropriate sources, including unit trust/OEIC managers, at the relevant pricing point²⁹. Where a price used is not obtained from an independent party, the firm will need to consider whether any additional steps are required to validate the price obtained.

4.4.3 Where no market valuation is possible then the Board is responsible for ensuring that clear, defined procedures exist and are applied to ensure a *fair value* is assigned to the relevant assets³⁰.

4.4.4 Where a transaction occurs between the firm and a connected party, this should be on a 'fair value' basis. Details of such transactions should be recorded and disclosed to the regulator on request.

Unit price rounding

4.4.5 Rounding is a necessary process used to simplify the pricing of unit-linked funds.

4.4.6 Firms will have an established approach to rounding, which should be clearly defined and monitored. The approach to rounding will typically be driven by IT systems and the other processes used to obtain underlying asset prices and to calculate the final unit price. Change to

²⁹ This may be derived from quoted bid and offer prices or based on quoted mid-prices

³⁰ Useful references include : IFRS Application Guidance for IAS39 – 2006 (AG74 to AG81), FSA's CIS Sourcebook (Ch. 4.8 *Valuation*) & COLL Sourcebook (Ch. 6.3 *Valuation and pricing*) and the IMA's Guide to Fair Value Pricing – September 2004 (See : <http://www.investmentuk.org/news/standards/Fairvaluepricing.pdf>)

these systems, particularly IT-related change, will often be complex and expensive to achieve and will require significant lead times.

4.4.7 However, as a matter of good practice :

- Rounding should be kept to a minimum and should not normally exceed 0.5% of the unit price.
- Rounding should be undertaken on a neutral basis³¹.
- Rounding should not be used as a method of levying a charge on the fund.

4.4.8 *Rounding limited to the 4th significant figure (or a maximum of 0.1% of the unit price³²) is recognised as best practice for firms to work towards. The pace at which firms can achieve this goal will depend upon a number of factors, including IT and systems constraints as identified above.*

4.4.9 In some cases, policy conditions will define the extent to which prices derived from the offer or the bid value of the fund may be increased or decreased (respectively) by a rounding factor to arrive at the published price. This may constrain the extent and pace of change possible, particularly in the case of older policies.

4.5 Charges

4.5.1 Charges should match their description in the policy conditions and other published material provided to policyholders³³.

Management Charges

4.5.2 Management Charges should be clearly defined and disclosed to policyholders³⁴.

4.5.3 Firms should be aware of the possible impact of double-charging. Where a fund invests in another in-house fund the firm should reduce or refund the additional charges either by rebates or by investing in a nil charge share class³⁵. Where the firm chooses to pass on additional

³¹ i.e. mathematical rounding to the nearest unit of price, rather than systematic rounding up or down of all 'odd amounts'

³² The 4th significant figure (SF) test gives rise to a large cliff-edge effect. For instance, where the price of a fund dips from £1 to 99.9p a 4SF requirement would need an extra decimal on the pricing system. But a system accurate to 1 decimal place with 'natural rounding' would still result in a maximum rounding error of 0.05% at 99.9p and under 0.1% down to a price of 50.1p.

³³ For some unit series (e.g. stakeholder) a cap on charges may apply and so some adjustments, such as a small deduction from the annual management charge may be needed to ensure that the cap is not inadvertently breached.

³⁴ This should include disclosure of how the asset value is calculated for charging purposes (e.g. whether based on net or gross assets under management).

³⁵ For existing funds that incorporate double-charging on in-house investments, firms should review previous disclosures and consider whether the existing arrangements meet the requirements of TCF.

fees to policyholders for externally managed funds, these should be clearly signalled in marketing literature.

- 4.5.4 All charges made to the fund, including the annual management charge and any other additional fees or investment management costs, will be subject to disclosure and illustration through the required approaches³⁶

Dealing Costs

- 4.5.5 Dealing costs will typically be charged to the fund and this should be clearly disclosed to policyholders. This should include taxes on dealing (such as SDRT³⁷). Dealing costs should be subject to review where significant changes in the market occur – for instance where there are changes to the rate of SDRT.
- 4.5.6 Allowance for such costs are often made in unit pricing. For instance, allowances may be added to the offer prices or deducted from the bid prices of the securities held. Any charges applied should reflect known or expected dealing costs and transaction terms³⁸.
- 4.5.7 Where dealing cost allowances are used they should be reviewed at least once per year and any changes implemented in a timely manner.

Other charges

- 4.5.8 Where any other charges are levied on the fund (for example custody costs) these must be in accordance with the relevant policy conditions and unless otherwise specified and disclosed should be charged on the basis of actual costs incurred.

Tax

- 4.5.9 Where the fund is subject to tax the following principles should apply :
- Policyholders should be treated fairly.
 - The firm's approach to tax should, as far as possible, be consistent with any information or commitments given in marketing literature or policy documents.
 - The basis of taxation chosen should aim to achieve broad equity between generations of policyholders and fairness between the company and the fund, supported by appropriate reconciliation to help ensure that a fair outcome has been achieved³⁹.

³⁶ Typically Reduction-in-Yield calculations.

³⁷ Stamp Duty Reserve Tax

³⁸ This may be most pertinent to Unit Trust and OEIC transactions where terms and costs may vary.

³⁹ Without perfect foresight it will not be possible to achieve perfect equity, but the goal should be to balance the interests of different generations of policyholder and achieve a fair allocation of the burden.

4.5.10 The scope and nature of the taxation of unit linked life funds may be subject to change over time, but wherever possible announcements of future changes should be taken into account in any tax calculations.

4.6 Error Correction

Overview

4.6.1 Pricing errors arise, typically, from a mistake in administration or processing. However, an adjustment to a unit price does not necessarily mean there has been an error, but instead may reflect a change from an estimated asset value included in a unit price, which is later adjusted when the actual value becomes known. Neither the price quoted before the change, nor the price derived after the change is in error, provided that these prices were arrived at using soundly-based policies, consistently applied⁴⁰.

4.6.2 Where such a change is to be made to a unit price, the change should be made as quickly as possible and should not be phased over time.

4.6.3 However, where errors do occur, these should be quickly identified and any systemic issues rectified. Where a complaint is made by a policyholder, it should be investigated fairly and resolved without undue delay. Compensation should be paid where appropriate⁴¹.

Pricing Errors

4.6.4 Set out below is a suggested criteria for investigating and resolving pricing errors :

of tax between the firm and the fund, recognising the tax relief which may be claimed on management expenses.

⁴⁰ However, firms will need to consider carefully how they respond to *incorrect* price or valuation information provided by third parties. In particular, where investors have lost out it may be appropriate to provide compensation (regardless of whether the firm intends to take action against the third party).

⁴¹ Further rule requirements and guidance on complaints handling may be found in the FSA handbook, in chapters 1 and 2 of *DISP* – the Dispute Resolution Complaints Sourcebook.

<i>Price error</i>	<i>Action</i>
Below 0.1%:	Errors are recorded but not normally investigated ⁴² .
Between 0.1% and 0.5%.	Errors are recorded and investigated for possible wider implications. Compensation may be considered but not normally required ⁴³ .
0.5% or above.	Errors are recorded, corrected and investigated for possible wider implications. Compensation would normally be paid.

4.6.5 The Board must, at all times, be satisfied that appropriate and reliable systems and controls are in place. Any review of the wider implications of a pricing error must consider any possible systems and controls failings.

4.6.6 The Board are responsible for providing oversight⁴⁴ to this process to ensure that any significant or recurring failings are swiftly and effectively remedied.

Reporting to the FSA

4.6.7 Pricing errors may be significant in themselves but may also be symptomatic of other process or control weaknesses. Accordingly, where significant or persistent failings have occurred it is likely to be appropriate to share this information with the FSA. The FSA Handbook sets out a number of requirements in respect of those matters having “a serious regulatory impact”⁴⁵, although firms may wish to go beyond this basic requirement to disclose all non-trivial pricing errors.

Speed of correction

4.6.8 Where an error is identified in the quoted fund price, the price should be corrected and implemented as soon as possible. There should be no phasing or ‘smoothing’ over a number of days (or pricing points) between the incorrect price and the correct price.

⁴² However, consideration should be given to the possibility that the error is evidence of wider failings which would merit investigation.

⁴³ Except where the firm identifies a widespread, systemic error likely to have resulted in losses above £50 for individual retail investors.

⁴⁴ Whilst the day to day monitoring may be delegated to a management committee or other function holder, the Board retains ultimate responsibility.

⁴⁵ See SUP 15.3.1R

De minimis criteria

4.6.9 It may be appropriate to apply de minimis criteria to compensation payments, where the error has resulted in an immaterial loss to the investor. The threshold of immateriality will depend on a number of factors including :

- Whether it is a retail or wholesale customer who is affected.
- The scale of investment.
- The relative costs of providing redress against the scale of compensation due.

4.6.10 Clearly, the outcome to be avoided is one where costs for the wholesale policyholder in processing the compensation exceed the value of the compensation. It may be possible to make redress in forms other than cash, e.g. by allocation of extra units or reduced collection of a future premium. This may attract lower costs and be more practical for small amounts and so preferred by the investor.

4.6.11 For retail customers, even where compensation is by means of a cash payment, compensation should normally be paid where the amount due is greater than £10, or such other amount as agreed by the Board⁴⁶.

4.6.12 For wholesale customers arrangements will vary according to a number of factors and may be governed by specific terms in the customer's agreement. Where there is any doubt, the assumption must be one of disclosing the errors with an offer of payment of compensation.

4.6.13 Where a pricing error has resulted in overpayment to a customer, the firm will need to carefully consider whether it is appropriate to seek recovery of the overpaid sum. It is likely that a higher disregard threshold will apply in such cases, taking account of the costs and inconvenience to the customer. However, in all cases the firm will put right any loss to the fund.

Timely payment of compensation

4.6.14 Firms are reminded of the importance of making timely compensation payments. Excessive delays should be avoided wherever possible. Firms are reminded of the requirements set out in the FSA Handbook for the resolution of complaints, which include a number of relevant time limits⁴⁷.

⁴⁶ Firms should carefully consider their approach to redress and where the firm's systems allow for easy and cost-effective redress for retail investors then it may be appropriate to compensate for the loss in some form, even where the amount concerned is below the suggested £10 threshold for cash payments

⁴⁷ See DISP Ch 1.4

4.7 Emergency situations / Disaster Recovery

4.7.1 There may be occasions where exceptional circumstances prevail - in times of crisis or disaster. In such circumstances it may be appropriate to use additional powers or discretions to secure the longer-term interests of the fund. This may include, but is not limited to :

- Temporary suspension of trading.
- Temporary suspension of unit price.
- Diverging from stated investment strategy (e.g. % equity invested).

4.7.2 Firms should document the scope of these powers and discretions reserved for emergency use. However, it is recognised that not all circumstances and not all possible responses can be foreseen in advance.

4.7.3 The overarching principle must be that emergency powers will be used only to the minimum extent necessary to secure policyholder protection and will be time-limited. Beyond any reporting requirements in the FSA Handbook, where significant breaches to normal policyholder conditions occur and this has a material impact on policyholders, the firm will review the impact of its decisions and consider additional disclosures to the regulator, and where appropriate, policyholders.
