ABI GUIDE TO GOOD PRACTICE

FOR UNIT-LINKED FUNDS

Fourth edition

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Association of British Insurers | One America Square | London EC3N 2LB | Telephone 0207 600 3333 | abi.org.uk

Update July 2023: **FCA requirements under the Consumer Duty take effect for open book products from July 31st 2023, and for closed book products from July 2024. Please note this guide has not been updated to reflect the Consumer Duty requirements. Firms choosing to apply this guidance alongside the Consumer Duty must take their own steps to ensure their approach and conduct is in line with these requirements. Future plans for the guide will reviewed through the ABI's five-yearly update process, due in 2024.**

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1. INTRODUCTION

1.1 This Guide of good practice ("the Guide") establishes guidelines that the Association of British Insurers (ABI) believes all firms managing unit-linked funds should aspire to and work toward.

1.2 The Guide has been prepared recognising that there is not currently a detailed set of rule requirements placed on those operating unit-linked funds. Instead, regulators 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 the FCA's permitted links for investments and for UK Solvency II firms, restrictions on investments arising from the Prudent Person Principle in the PRA Rulebook.

1.3 The guiding principle throughout this document is that firms must act in accordance with the FCA's Principles for Business, including the need to comply with Treating Customers Fairly (TCF) requirements, which form part of the FCA Handbook. Treating Customers Fairly incorporates a number of elements, including 'Policyholders' Reasonable Expectations (PRE) and Clear, Fair and not-misleading customer communications but is a much broader concept. Treating Customers Fairly applies equally to existing, long-standing and new customers in open or closed books.

1.4 This is the fourth edition of the Guide, which has been updated by a working group of the ABI to ensure it remains appropriate and up to date and provides some updates in the context of relevant key regulations implemented since its last publication in 2014.

1.5 It is recognised that some funds will have either a significant or exclusively institutional investor base, which may influence how the guidelines of this document are applied. Wholesale fund parameters will differ in some areas and in these cases firms may reasonably depart from the guidelines indicated as appropriate to retail customers.

1.6 The ABI consulted with the FCA in developing the guidelines in this document, however this Guide does not constitute guidance from the FCA. In the event of conflict between the Guide and the FCA Handbook, the FCA's Handbook text prevails.

1.7 However, this Guide does establish guidelines that the ABI believes all firms operating unit- linked funds in which their unit-linked policies invest should aspire to follow, taking into account their financial and other circumstances. The FCA supports this initiative.

1.8 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 delivering Good Customer Outcomes. Alternatively, if they cannot meet the guideline set out in the Guide (or an equivalent), they should be able to explain why such a guideline would not be appropriate to their circumstances – for instance on grounds of materiality or disproportionate cost.

1.9 The Guide is intended to be a practical, 'living' document, more flexible than a rule-book based solution and able to adapt to emerging thinking and good practice. We expect to review the Guide at least every five years (more frequently if changes in regulation or best practice would justify an earlier review) to ensure that it remains appropriate and up to date.

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2. FUND GOVERNANCE

2.1 Firms should maintain adequate governance arrangements to ensure that unit-linked funds are managed appropriately and in accordance with policy disclosures. It should be noted that the structure and complexity of unit-linked funds and the associated policy conditions and disclosures vary by firm. For some firms, changes over time or business consolidation activity mean that a number of variations need to be managed. Detailed governance arrangements will therefore vary by firm.

2.2 However, the governance structure will typically include:

The Board

2.3 The Board carries ultimate responsibility for the governance of unit-linked funds including oversight of both investment management and operations, along with ensuring fair treatment of customers. The Board must ensure that the firm has adequate systems and controls to administer and manage funds fairly, that assets backing unit-linked policies are appropriate for customers and that customer benefits are calculated fairly and accurately.

2.4 The Board may delegate duties to senior committees or individuals. The committees may, in turn, be supported by specialist sub-committees or working groups.

Committees

2.5 Firms will typically use committees in their governance structures. The naming and duties of such committees, for example, a "Unit Pricing Committee" or "Product Development Committee", will vary by firm and this Guide does not seek to impose a set structure on firms.

2.6 The key principle is for appropriate governance arrangements to be in place, with:

- clearly defined responsibilities
- appropriate structures for decisions to be challenged
- appropriate scope
- policies and procedures that outline their rationale and are documented

Roles and Responsibilities

2.7 The Board and all relevant committees, sub-committees or working groups should have documented terms of reference which clearly articulate roles and responsibilities in respect of fund governance including the oversight of key operations.

2.8 The Board should ensure that it is provided with sufficient information to allow it to discharge its responsibilities and provide appropriate structures for decisions to be challenged.

2.9 The Board should also consider the structure and composition of any committees, sub- committees and working groups, and those which focus on specific technical issues, to ensure opinions and actions are balanced and that the appropriate structures are in place for decisions to be challenged.

Scope of governance

2.10 The scope of required governance will depend, in part, on firm-specific structures and operations. Governance arrangements in relation to unit-linked business typically cover the following:

- ***Valuation and Pricing***
  - Definition of standards and policies for the operation of the linked funds
  - Oversight of unit pricing arrangements
  - Setting and monitoring of accuracy and timeliness targets
  - Monitoring of box levels and any profit or loss arising on any box, and the nature of those profits and losses.
  - Seeking to ensure fair treatment of customers in the application of the unit pricing process

- ***Fund development and monitoring***
  - Consideration of appropriateness of new fund offerings for the target market
  - Consideration of continued appropriateness of existing fund links for policyholders, including review of long-standing customers
  - Consideration of any fund mergers or closures
  - Review and approval of marketing materials and policy disclosures
  - Consideration of the impact of any fund changes or developments on operational capabilities and procedures
  - Consideration of any conflicts of interest that may arise as a result of fund developments
  - Consideration of fair treatment of all customers in the development and on-going administration of funds

- ***Investments and mandate compliance***
  - Consideration of and monitoring adherence to the permitted links rules, and for UK Solvency II firms, investment rules arising from the Prudent Person Principle
  - Consideration of the use and type of derivatives and stock-lending including appropriate collateral arrangements and, for stock-lending, revenue sharing arrangements
  - The content of investment mandates
  - Monitoring of mandate compliance
  - Monitoring of fund performance against fund objectives and (where applicable) benchmarks
  - Consideration of actions following a breach of mandate or a breach of regulations.

- ***Outsourcing***
  - Oversight of functions outsourced to companies within the same group, and to third parties, including the information and resources they need to fulfil their duties.

2.11 In addition, firms are expected to have wider governance policies in place that would typically cover the day-to-day management of the firm, risk management, compliance and internal audit.

Outsourcing

2.12 The Board may choose to outsource certain functions to third parties, for example fund management and unit pricing/valuation activities. Where this is the case, the Board should exercise skill, care and diligence in the selection and continuing oversight of the third party, including the carrying out of appropriate due diligence before entering into the arrangement and having the appropriate systems and controls in place to manage the risks presented during the arrangement.

2.13 A firm cannot contract out its regulatory obligations and should take reasonable care to ensure that any third party is supervised and discharges its outsourced functions appropriately. Particular care should be taken where these activities constitute a material outsourcing arrangement. Intra-group arrangements will also not necessarily result in a reduction in operational risk and firms should equally apply appropriate controls in respect of such arrangements.

2.14 The nature and extent of the systems and controls that should be put in place to oversee the operation of its unit-linked funds will depend upon a number of factors, including:

- The nature, scale and complexity of the firm's business and the overall risk presented in the outsourcing of that activity
- The diversity of its operations in relation to its unit-linked funds
- The geographical location of the service provider
- The volume and size of relevant transactions
- The degree of risk associated with the operations of outsourced firms

2.15 In entering into and considering its oversight of third party service providers, the following factors should be taken into account:

- How the arrangements fit with its overall organisation and operation of unit-linked funds.
- Formalising the arrangement by way of a comprehensive legal contract
- Consideration of the structure of agreements to be put in place and whether it is necessary to put in place additional governance arrangements to manage the service provision. Such additional governance could include the oversight by the Board or committees that oversee the operation of the unit-linked funds
- Conducting due diligence at outset and on an ongoing basis both on the operational delivery but also on financial stability of the third party supplier and the firm's concentration risk with the supplier(s) involved
- Oversight activities in a firm's compliance monitoring
- Business continuity and disaster recovery plans in place at the supplier firm also taking into account its geographical location
- Exit planning and transitional arrangements resulting from operational difficulties, financial distress of the third party supplier, or in the event of a termination event
- Audit rights, to include access to relevant policies, procedures, systems and controls relating to all relevant activities.

2.16 The firm should have an appropriate understanding of outsourced activities relating to its unit-linked business. Its oversight of the outsourced activities should consider both quantitative and qualitative risk-based measures including regular and reliable management information.

2.17 Examples of management information that firms should be receiving are:

- Key Performance Indicators against defined services and service levels
- External validation reports
- Key Risk Indicators.

2.18 In respect of unit-linked business processes, firms should, in addition, review management information and validate that operational processes are working effectively. This may include using the firm's oversight and audit rights and validating the third parties' own control environment.

2.19 Where a firm relies on a company within the same group to provide a service for that firm (for example a Group risk function or a Group valuation committee) the Board must ensure that the level of assurance or role provided by such a function or committee is sufficient given the nature, scale and complexity of its operations. In particular, any matters of a specific unit-linked nature should be clearly identified and documented as part of the responsibilities of the function or committee and there should be clear reporting lines to the Board or senior committees of the firms that have written unit-linked business. The Board should also ensure that it is able to exercise appropriate influence at Group level, and is in control of any actions taken on its behalf within the Group.

2.20 Where the third party also outsources activities to sub-delegates, firms should ensure that they have sufficient oversight of the whole chain of service provision.

Conflicts of interest

2.21 Firms must identify whether any conflicts of interest exist, or may arise in relation to their management of unit-linked funds. If so, firms must determine how these conflicts will be managed in order that customers or groups of customers, or any other stakeholder(s) or groups of stakeholders, are not unfairly disadvantaged to the benefit of others.

2.22 Firms should ensure they have a clear conflicts policy covering all aspects of their business. The policy should set out, for example, its scope and purpose, how conflicts will be identified, recorded and managed, who is responsible for maintaining the policy and ensuring adherence to it and how exceptions will be dealt with.

2.23 Examples of conflicts that might arise include, but are not restricted to, those between:

- shareholders and customers (e.g. seeding of unit-linked funds and box management)
- different customer groups (e.g. with-profits and unit-linked customers)
- different generations of unit-linked customers (e.g. policies sold in different periods/with different policy terms), including long-standing customers
- different group companies (e.g. where services are outsourced within the Group)
- employees or directors and customers

Documentation

Internal documentation

2.24 It is good practice to maintain adequate documentation relating to the operation and governance of the unit-linked funds. As a minimum, the following is expected:

- Documents that set out the firm's intended unit pricing methodology including policies on material areas of discretion. The documentation should contain sufficient detail to explain and justify the approach taken and include (but not be limited to):
  - the valuation of assets (including fair value pricing when no market valuation is available)
  - triggers for pricing basis changes
  - allowance for tax
- Operational procedures
- Terms of reference for the Board, committees, sub-committees and working groups
- Papers submitted to the Board, committees, sub-committees and working groups
- Minutes of all relevant Board, committee, sub-committee and working group meetings

2.25 Standards and policies should be reviewed periodically.

External documentation

2.26 Whilst this Guide, in conjunction with the relevant regulatory rules and principles, provides a high-level framework, the individual policy conditions should define in more detail the boundaries within which a firm 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 firm 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.

2.27 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 customers. 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. There should be mechanisms in place for customers to receive clear and timely communications. For products in scope of the PRIIPs regulations, firms should produce a KID (Key Information Document) for each of the funds within the product. These KIDs should be easy for customers to access.

2.28 Taken together, all the information provided to customers should enable them to understand at a high level how the firm operates the fund and manages their investments. It will also provide the FCA with a clear statement of the standards applied to the fund, offering a criterion against which to review the fund's operation.

3. FUND LAUNCHES, MERGERS AND CLOSURES

Overview

3.1 Firms have discretion over a number of aspects of the management of unit-linked funds. Firms must ensure that in exercising discretion policyholders are treated fairly.

3.2 Firms may wish to bear in mind the following guidance when considering proposals to launch, merge or close funds.

Launches

3.3 When launching a new fund, firms should consider:

- The size of initial seeding (e.g. to ensure the fund is of sufficient size to follow its investment mandate, to reduce operational risk if the fund expands quickly and to ensure an acceptable initial total expense ratio, unless expenses are subsidised during early life)
- That the name of the fund is consistent with its published aims and investment mandate
- The clarity of the published fund aims and the mandate of the investment manager
- Compatibility with any charge caps that may apply
- Any charges and transaction cost disclosure and the production of a KID for funds launched into products which are in scope of the PRIIPs regulations.

Mergers/Closure

3.4 Mergers and closures could be initiated for a number of reasons. These might include, but are not limited to, operational considerations, corporate changes (e.g. life company mergers or entity reorganisations within a group), governance reasons (e.g. continued poor performance), external corporate actions (e.g. closure of an underlying OEIC), small fund sizes leading to high total expense ratios for policyholders.

3.5 The following list of considerations is not intended to be an exhaustive list but an indication of the type of considerations that need to be taken into account when making the decision to merge or close funds.

- Sufficient consistency of fund investment aims and risk profile between the merging funds.
- Policy conditions regarding rights to close funds and notice periods.
- The implications for future tax charges relative to the un-merged state.
- Any differences in allowable charges/deductions or past practices.
- The implications for future choices of pricing basis (bid or offer) and the impact on different groups of policyholders.
- Whether to execute the merger by cash or in specie transfer, and any phasing (e.g. to minimise dilution levies borne by the funds).

- Valuation prices for hard-to-value or illiquid assets, particularly if they form a significant part of any of the merging or closing funds.
- Communications, including any default if no customer action is taken and any free switches being offered.

4. FUND OPERATIONS

Operating Standards

4.1 Openness and transparency are fundamental concepts that underpin the principle of Treating Customers Fairly. The guidelines set out in this Guide strongly support this open and transparent approach.

4.2 Firms must ensure they have appropriate capabilities in respect of their unit-linked operation and that the firm has an appropriate skill base capable of understanding the overall unit-linked operation and being able to challenge all aspects of the operation, whether it is on pricing, valuation, box management or taxation. This applies irrespective of whether a firm carries out unit-linked operations themselves or has outsourced aspects of unit-linked operations to third party providers.

4.3 Wherever possible, processes and decisions should be documented by the firm with relevant information made available to the regulator.

Communications to policyholders

4.4 Firms must ensure that they make it easy for customers to access information relevant to their investment decisions, whilst not being expected to provide information which would enable customers to exploit that information to the disadvantage of other policyholders or the firm. 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 request.

4.5 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 follow the guidelines 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.

4.6 In short, it is about empowering policyholders with concise and relevant information. Where appropriate, policyholders should be provided with relevant technical information but they should not be swamped with a mass of technical, abstract disclosures that they are unlikely to need, read or ever understand.

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Use of Discretion in Managing the Fund

4.7 Where discretion is exercised in the management of the fund, it is very important to ensure that the firm treats its customers fairly.

4.8 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 parties, where appropriate, and reviewed when required. This documentation provides a clear point of reference against which to review any decisions taken, helping to provide clarity and certainty for all parties.

4.9 Robust and effective reporting structures should be in place to allow the Board to monitor the exercise of this discretion on an on-going basis, to ensure that policyholder interests are safeguarded.

4.10 Areas where discretion may be applied include:

- Allowing for dealing costs
- Unit price rounding
- Changes to investment profile or risk assessment of assets
- 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 removed from or credited to the 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 bases
- Internal deals between two unit-linked funds
- Management of fund liquidity
- Ability to defer switches/surrenders in adverse market conditions
- Ability to defer transactions by customers seeking to exploit market timing opportunities
- Valuation of assets – especially where market prices do not exist
- Determining, if applicable, distribution rates for income
- Choice of pricing point of the linked fund
- Frequency of pricing
- Addressing breaches of policy conditions or other customer commitments and dispute resolution
- Launching funds and seeding with shareholder capital

- Merging funds
- Ability to close a fund to new business or switches in and the ability to close a fund completely.

Discretion in relation to some of these items may be subject to the terms of the original policy conditions, or in some cases to commitments given in schemes enacted under Part VII of the Financial Services and Markets Act 2000.

Mandate compliance

4.11 Firms should ensure that they have sufficient information about the assets in which their funds invest in to ensure they meet customer expectations. For all funds, firms should ensure that:

- The asset description given to customers within their documentation is consistent with that used by the investment manager.
- Procedures are in place to provide timely reports on:
  - Investment performance
  - Non-compliance (for example asset mix breaches)
- Procedures are in place on the reporting processes within the firm and to the regulatory supervisor.

4.12 For funds where the investment strategy is set and managed by investment managers external to the firm (or the group the firm is a member of), firms may want to achieve this by seeking a data provision agreement with the investment manager. This agreement would complement the general prospectus governing the fund in which the firm is investing on behalf of its customers. For example, regarding particular additional areas of focus for consideration within the agreement could be the timely delivery of prices to the firm, error reporting and notification of changes to the fund.

4.13 For funds where the investment strategy is set by the firm (and hence usually managed by the firm or by the investment house within the firm's group), the firm should establish investment mandate agreements. These mandates may want to include:

- The fund's objectives with accompanying performance measures
- Allowable assets with any restrictions such as counterparty limits
- Provision of performance data
- Usage of derivatives and reinsurance
- Whether stock lending from the fund or by the fund is permitted (and if so the approach)
- Authorisation approach for changes to the:
  - objectives of the fund
  - operation of the fund.

Stock lending

4.14 Firms may choose to participate in stock lending as a lender with an authorised counterparty.

4.15 If customers' funds bear any risk of counterparty default risk then:

- The extent of the risk must be appropriately disclosed to customers
- The funds must receive proportionate benefits accruing from the transaction, less fees and expenses (for example if the whole of the risk is borne by the customer's funds then they should receive the whole of the recompense (net of fees and expenses)
- Fees and expenses must be reasonable and reflect cost of undertaking these activities.

4.16 If customers' funds are fully indemnified against counterparty default risk then the fund must receive fair and reasonable recompense for the use of their assets.

Regulatory requirements for unit-linked investments

Permitted Links

4.17 The FCA's Handbook sets out the principles and rules with which firms must comply when engaging in linked business.

4.18 Firms should be mindful of their target market and ensure that they conduct sufficient analysis to enable them to make informed decisions about whether assets are appropriate as permitted links.

4.19 Where firms are offering exposure to third party firms' collective investment schemes (CIS) or reinsured funds they need to have appropriate arrangements in place to ensure that the underlying fund is operating as expected and that any issues arising are dealt with appropriately.

Solvency II Prudent Person Principle

4.20 The PRA Rulebook sets out the principles which Solvency II firms must comply with when investing its assets. This includes the Prudent Person Principle that firms must comply with when engaging in linked business. Among other requirements:

4.21 A firm must only invest in assets or instruments whose risks can be properly identified, assessed and understood.

4.22 A firm must ensure that the assets of its unit-linked funds are invested in a manner appropriate to the nature and duration of its liabilities to its policyholders, and in the best interests of all policyholders, taking into account any disclosed policy objectives.

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5. VALUATIONS AND UNIT PRICING

Pricing issues – overview

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

1) The pricing mechanism or box management processes should not be used as a deliberate means of extracting value from the fund or from policyholders.

2) Cross-subsidy among policyholders or individual funds should be minimised as far as reasonably possible.

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

5.3 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.

5.4 In order to ensure fairness to customers leaving, staying in and joining a fund, the deferral of transactions on a fund may be required. In such circumstances the following consideration should be made:

- Ability of the fund to trade assets at a fair price in line with customer transactions
- Level of customer transactions being experienced
- Maintaining an asset portfolio that is appropriate for customers and in line with the fund aims
- Deferral rights as set out in customer terms and conditions
- Communication to all policyholders, including existing, long-standing and new customers, in both open and closed books
- Whether all transactions on that fund are deferred or whether some transactions will be allowed to continue as normal (e.g. maturities).

Pricing models

5.5 Whilst there are many possible permutations in the method for calculating fund prices and applying them to customer transactions, at its simplest there are two different approaches:

1) ***Forward pricing*:** This involves calculating the price at which the transaction is undertaken after the transaction 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 transaction is done, based on an existing (i.e. historic) valuation of the assets in the fund

5.6 The firm must carefully consider the effect of its chosen pricing model on 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.

5.7 A historic pricing model has the attraction of allowing customers to transact at a known price, rather than having to wait until after the transaction 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 investments.

5.8 Whereas, in its purest form, a forward pricing approach should ensure that the price for a customer's transaction precisely matches the value of the underlying investments backing those units. This eliminates the risk of any potential mismatch between the dealing price and the value of the underlying investments.

5.9 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.

Pricing frequency and unit transaction timing

5.10 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 other 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 in such a way as to minimise the risk of any significant distortion or deviation
- Avoiding any material geared exposure to market movements of the fund or policyholders by considering the relative timings of net policyholder unit transactions and the related asset purchase or disposal
- Avoiding any material additional market exposure 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.

Pricing frequency

5.11 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 policyholders.

Pricing basis: switching between bid and offer pricing

5.12 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.

5.13 Firms may take a variety of approaches to the selection of the pricing basis. It may be appropriate to switch the pricing basis from time to time to protect the interests of continuing policyholders.

5.14 Firms should apply a principle that the customer(s) causing the pricing basis change to take place should have the price change applied at the right time to impact on their transactions, otherwise detriment could occur for customers who are unconnected to the changing direction of flows.

5.15 Where the fund applies a dilution levy, a similar principle applies, in that the levy should be applied to those customer(s) who are causing the levy to be applied to avoid dilution of the fund.

5.16 The overall purpose should be to ensure broad neutrality between new, continuing and outgoing policyholders, so as to avoid any material concentration or dilution of the fund arising from customer transactions. Where customers are causing funds to incur transaction costs, those customers should have allowance made for the actual or expected costs in their transaction to reduce the impact on other customers in the fund.

Historic pricing

5.17 As discussed above, any pricing model which relies on past data to determine the unit price of the fund will carry the risk of mismatch between the unit price at which the customer transacts and the underlying value of the units at the point of the transaction.

5.18 Firms should ensure that where a mismatch can occur that appropriate controls are in place to ensure there is no material customer detriment arising where customers seek to take advantage of any mismatch or potential arbitrage.

5.19 Whilst fully prospective pricing and valuation of assets would be unrealistic in most cases, given the delays to settlement this could imply, firms should seek to ensure that the price and valuation information used is as up-to-date as possible.

5.20 Where a firm identifies a significant movement in asset values 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. Amongst the factors to take into account in choosing to do so will be the terms at which the company, fund and transacting customers deal with each other.

Market timing

5.21 Where a firm transacts on the basis of historic prices and/or asset valuations, then certain additional safeguards should be considered, both to protect against strategic dealing activity and to ensure fairness to policyholders.

5.22 Such safeguards may include:

- Deferring execution of deals; or changing the cut-off timing for deals
- Temporarily suspending the right to deal for customers believed to be engaged in market timing activity
- Restricting access to, or withdrawing, funds which have market timing opportunities
- Moving to a 'fair value' model of pricing
- Moving to a forward pricing model.

5.23 Any action should take account of policy conditions.

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

5.25 Firms should ensure they have access to appropriate information and have sufficient controls in place to be able to identify any customers who may be actively trading their funds as this could be an indication that these customers are potentially seeking to take advantage of market timing opportunities.

5.26 Firms should be mindful of how market timing may impact on other customers and take appropriate action to mitigate the impact on them. Where possible, the firm should take action to stop the customer from being able to take advantage of these opportunities (this may be from applying customer restrictions, changing pricing timing, changing dealing cut- off times). In taking any action, firms should be mindful of any policy conditions that apply.

Transaction processing

5.27 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

5.28 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 base. 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.

5.29 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 profit from the fund through strategic management of the box.

5.30 Risk-free profits should be returned to the fund in full and not retained by the firm. Effectively where a fund is dual-priced, any dilution levy applied to transactions should be credited to the fund and there should be no netting of transactions to allow the shareholder to extract dilution levies paid.

5.31 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 apply:

- The company must hold assets whose value matches the unit-linked liability as closely as possible
- 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 material deviation from the box management policy should be recorded and justified
- Unit creations/cancellations by the box manager, and inter-fund cross-holding transactions should be carried out on a basis that will meet Treating Customers Fairly requirements.

Cash transaction timing

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

Valuations

5.33 Firms should have a written valuation policy. The policy should document policies and procedures associated with the valuation process including:

- Oversight of the valuation process
- Procedure to ensure that financial instruments held by funds are valued consistently and fairly
- Circumstances where fair value determinations may be appropriate, together with an outline of the method used.

5.34 Where possible, assets will be valued at current, recognised and independently-assessed prices.

5.35 Prices for securities should be derived from recognised sources including market data providers, unit trust/OEIC managers, stock brokers or other appropriate sources.

5.36 The valuation time of the assets should be checked to ensure that it is consistent with the relevant pricing point of the fund. Some sources only record Close of Business prices of assets. If indexing a fund, the index values used should relate to the same relevant pricing points as the fund

5.37 Where a price used is not obtained from an independent party, or the market valuation is not considered reliable, the firm will need to consider whether any additional steps are required to derive or validate the price obtained. It may be appropriate to consider a hierarchy of more than one source of information in arriving at the fair value.

5.38 Where no market valuation is possible, clear, defined procedures should exist and be applied to ensure a fair value is assigned to the relevant assets.

5.39 The use of stale prices or use of indexed stale prices should be avoided where an up-to- date price is available, as it may discriminate unfairly against new or existing customers and the routine use of stale prices may result in pricing errors. In volatile markets it may significantly increase the risk of strategic dealing activity (market timing).

5.40 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.

5.41 A firm should have processes in place to deal with situations where valuations are expected to be unavailable, such as bank holidays in different countries.

5.42 A firm should have documented contingency plans in place to deal with unexpected lack of valuation information or other delays in information becoming available.

5.43 Processes for dealing with situations where prices are unavailable may include suspension of pricing, use of stale prices, or use of previous prices adjusted by an index.

5.44 A firm should have in place reasonable controls to prevent errors. This may include checking individual asset valuations compared to daily tolerance levels. Areas of higher risk, such as manual entry of information, should be subject to appropriate levels of checks and controls.

5.45 A firm should ensure its pricing functions have adequately skilled/suitably experienced and resourced staff to perform specialist valuation/judgement for any funds or asset classes that their funds are allowed to link to.

Unit price rounding

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

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

5.48 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 basis.
- Rounding should not be used as a method of levying a charge on the fund.

5.49 Rounding limited to the 4th significant figure (or a maximum of 0.1% of the unit price) is recognised as good practice for firms to work towards. If investment performance is anticipated to be low, firms should consider whether to move to a more precise pricing basis. The pace at which firms can achieve this goal will depend upon a number of factors, including IT and systems constraints as identified above.

5.50 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.

Charges

5.51 Charges should match their description in the policy conditions and other published material provided to policyholders in line with applicable regulations.

Management Charges

5.52 Management charges should be clearly defined and disclosed to policyholders.

5.53 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 class. Where the firm chooses to pass on additional fees to policyholders for externally managed funds, these should be clearly stated in marketing literature.

5.54 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 approaches.

Transaction costs

5.55 Transaction costs will typically be charged to the fund. The fact that these costs are charged to the fund should be clearly disclosed to policyholders. This should include taxes on dealing (such as Stamp Duty Reserve Tax - SDRT). Transaction costs should be subject to review where significant changes in the market occur – for instance where there are changes to the rate of SDRT.

5.56 Allowance for such costs is 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 explicit and indirect transaction costs and transaction terms.

5.57 Where transaction cost allowances are used they should be reviewed at least once per year and any changes implemented in a timely manner.

5.58 The disclosure of transaction costs and the method to do so will depend on the product type and rules that apply to any such disclosure.

5.59 FCA rules require operators of workplace pension schemes to obtain (as far as they are able) and disclose information on transaction costs to scheme governance bodies, including any Independent Governance Committee, following a request from those bodies.

5.60 Additionally, the Occupational Pension Schemes (Administration and Disclosure) (Amendment) Regulations 2018 also introduce requirements on trustees and managers of occupational pension schemes to disclose these costs to members.

5.61 Operators of workplace pension schemes are reliant on the calculation and provision of this information from the firms that hold the data, principally fund management companies.

5.62 Firms may wish to establish regular reporting from fund managers in order that these requests can be met on a timely basis. Though fund manager reporting is likely to be provided on industry-standard templates, firms may nevertheless wish to provide explanatory documentation to help users understand the information provided.

Other charges

5.63 Where any other charges are levied on the fund (for example custody costs or all or part of the initial charge on purchasing unit trusts or OEICs) 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. If not material other charges can be accrued on a best estimates basis.

5.64 Charges calculated and published within customer literature should be in accordance with FCA Handbook requirements.

Tax

5.65 Under the tax regime applicable to UK life assurance firms, basic rate tax on the policyholders' investment return from investing in a life product is assessed on the life assurance firm itself. For unit linked business, the firm therefore levies charges in respect of taxation on the unit linked funds.

5.66 The firm's approach to tax will often be outlined in the policy documentation. The methodology for making tax charges to the unit linked funds should be consistent with any relevant information provided direct to customers or published more widely. The firm should amend such documentation when material changes to tax regimes arise which impact on charges to policyholders' funds. For funds where tax charging basis varies from the firm's disclosed approach, such variations should be disclosed, if material to the policyholder outcome.

5.67 The calculation of tax-related charges is complex, and there is not necessarily a single right answer to the treatment of tax in unit-pricing. However, the pricing methodology adopted should seek to preserve fairness between different generations of policyholders and between policyholders and shareholders.

5.68 Where the assets in the linked funds back taxable business (e.g. life bonds) the calculation and deduction of tax charges should be in accordance with the overarching principle of Treating Customers Fairly. The firm should document how its chosen basis of charging the funds in respect of taxation is appropriate to deliver a fair outcome as between customers and shareholders and as between different generations of customers.

5.69 The following factors should be considered when choosing the basis of levying charges in respect of taxation:

- The impact of tax balances in the fund as these can distort the risk profile of the fund (e.g. through gearing).
- Consistency with current tax rates and tax regime (with changes being implemented from the effective date of the change, unless equity demands otherwise).
- The appropriate value to be placed on deferred tax assets and liabilities.
- That the value of the fund takes account of any appropriate tax relief attributable to asset classes held in the fund.
- That appropriate procedures are put into place that are operationally robust, bearing in mind that taxation in pricing deals with future events whose outcome is uncertain.
- That appropriate relief is provided for external expenses charged to the fund.
- The level of discounting of tax rates where there is likely to be a prolonged period from the pricing date until the expected date of payment of the tax, for example on deemed and unrealised gains or losses. The approach to discounting should also be consistent with the settlement of tax provisions, or where relevant, the holding of cash or other assets within a fund against the provision, required to avoid accidental or inappropriate gearing of the fund.

5.70 The scope and nature of the taxation of UK life assurance firms, and therefore of unit- linked life funds, may be subject to change over time. Wherever possible, and where appropriate announcements of future changes should be taken into account in fund tax charge calculations.

In addition, firms should:

- Ensure that the offsetting of losses against gains before calculating tax liabilities is done fairly and consistently.
- Document their processes and procedures for offsetting gains and losses and have in place systems and controls to ensure those processes and procedures are correctly applied.
- Aim for consistency of approach in offsetting gains and losses and the rationale for any inconsistency should be documented with a view to ensuring that all policyholders are being treated fairly.

5.71 The investment return on pension business is not subject to corporation tax. However, taxes may be suffered on assets held to back pension business and the life company may be able to recover an element of such tax. Allowance for tax recoveries on pension funds should be done on an appropriate and consistent basis.

6. BREACHES, ERRORS AND MATERIAL INCIDENTS

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 the revision of estimated asset values. 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 applied.

6.2 Firms should ensure that appropriate systems and controls exist for the identification, prompt rectification and, where required, the reporting of errors and breach events. Consideration must be given to maintaining an open and transparent relationship with the regulator beyond the notification of high impact events. Ultimate responsibility for ensuring appropriate arrangements are embedded rests with the Board and senior management.

Identification

6.3 Firms must implement robust processes to identify and document events. Analysis to identify potential error themes or trends should be performed to ensure that recurring instances do not indicate, or build into, wider systemic concerns.

6.4 Administrative systems and controls, monitoring tolerances, and management information should be regularly reviewed to ensure that they are appropriate to the size, complexity, and level of risk of the business.

6.5 Where firms offer exposure to third-party collective investment schemes controls should exist to monitor the performance of funds relative to the underlying CIS and to ensure that they are given sufficient notice of material events (for example change of manager or change of asset allocation) affecting the fund. Arrangements for the rectification of pricing errors affecting underlying funds should be reinforced contractually.

Error correction

6.6 Error and breach events identified should be rectified in a prompt and timely manner. Events that disadvantage customers, or have the potential to do so, should be afforded a high priority with sufficient resources deployed. Lengthy delays in quantifying and resolving issues could indicate inadequate systems and controls.

6.7 Where an error is identified in the quoted fund price, any change to the fund's net asset value and/or price should be 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.

6.8 Firms are reminded of their duty to reimburse affected customers - past and present - unless the impact is reasonably deemed to be of minimal significance. Reasonable steps should be taken to identify and contact policyholders who have 'gone away'.

6.9 Corrections should not disadvantage other customers so it may sometimes be more appropriate to make corrections other than by changing the unit price, e.g. by allocation of extra units, reduced collection of a future premium or payment of compensation. This may attract lower costs and be more practical for small amounts.

6.10 It may be appropriate to implement, in agreement with the board, a threshold level below which the redress amount would reasonably be considered immaterial. These amounts need not normally be paid.

6.11 For retail customers, redress (whether by unit correction or cash payment) should normally be applied where the amount due is greater than £10, or such other amount as agreed by the Board.

6.12 For wholesale customers such arrangements may be governed by specific terms in the customer's agreement.

6.13 It may not be appropriate, practicable, or in some cases legally permissible, for firms to recover overpayments from customers where they have benefited from incorrect pricing. Any decision to seek recovery should weigh the costs and inconvenience to the customer and it is recommended that a suitably high disregard threshold apply. In all cases the firm will correct any material loss to the fund and may consider correcting any material profit to the fund.

6.14 Firms are reminded of the importance of making timely redress corrections and excessive delays should be avoided wherever possible. Where a customer complains about a particular error, firms are reminded of the requirements set out in the FCA Handbook for the resolution of complaints, which include a number of relevant time limits.

ABI

Pricing Errors

6.15 Set out below are suggested criteria for investigating and resolving pricing errors:

Price error	Action
Below 0.1%	Errors are recorded but not normally investigated (however, consideration should be given to the possibility that the error is evidence of wider failings which would merit investigation).
Between 0.1% and 0.5%.	Errors are recorded and investigated for possible wider implications. Action to put the customer back into the position that they would otherwise have been in may be considered but not normally required. [1]
0.5% or above	Errors are recorded, corrected and investigated for root cause and possible wider implications. Action to restore the fund and customer to the position that they would otherwise have been in would normally be required

Firms should be aware that small errors can build up over time into material issues.

6.16 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.

6.17 The Board is ultimately responsible for providing oversight to this process to ensure that any significant or recurring failings are swiftly and effectively remedied.

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

Notification

6.18 Pricing or other errors may be significant in themselves but smaller errors may also be symptomatic of process or control weaknesses and it is therefore likely to be appropriate to notify the FCA of any persistent failings.

6.19 Immediate notification of events having a serious regulatory impact is established, however the potential need to inform the regulator of non-significant breaches, and indeed any failure to meet the Principles for firms engaged in linked long-term insurance business, must also be recognised.

6.20 Firms should therefore discuss and agree a reporting format and frequency with their supervisory contact(s). The framework should be documented with clearly defined responsibilities.

7. EMERGENCY SITUATIONS / DISASTER RECOVERY

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 discretion 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. percentage equity invested).

7.2 Firms should have established governance processes to deal with such situations, with trigger and escalation points to unit-linked governance committees and relevant regulators, as appropriate, and 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.

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 FCA 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.