THE FINANCIAL SERVICES AND MARKETS TRIBUNAL

LEGAL & GENERAL ASSURANCE SOCIETY LIMITED Applicant

-and-

THE FINANCIAL SERVICES AUTHORITY Respondents

Tribunal: JUDGE DAVID MACKIE CBE QC
MS SANDI O'NEILL
MR PETER BURDON

Sitting in public in London

Mr Charles Flint QC and Mr Ben Jaffey, instructed by Freshfields Bruckhaus Deringer, for the Applicant

Mr Hodge Malek QC and Mr Simon Hattan, instructed by the FSA, for the Respondents

FURTHER DECISION

A. INTRODUCTION

1. We deal with three matters arising from our Decision of 18th January 2005 which required a further hearing:
(a) what penalty should be imposed on L&G for the rule breaches we have identified;
(b) should either party pay all or part of the other's legal costs;
(c) should we make statutory recommendations to the FSA?
We have received many further written submissions, and we held further hearings on 21st February and on 26th April. We now deal with each matter in turn. We adopt the same abbreviations used in our Decision.

B. PENALTY

2. The parties agree that the Financial Services and Markets Act and Orders made under it give the Tribunal power to impose the same penalties for rule breaches as the RDC and to require FSA to put those into effect. Our powers are wide but both parties agree that we should approach the imposition of penalties in accordance with the FSA policy currently contained in Chapters 12 and 13 of its Enforcement Manual. As there has been no criticism of that policy and we see no reason to depart from it we will apply it.

3. In this type of case there are in practice three available sanctions - private warning, public censure and financial penalty. Private warning would be inappropriate first because of the public nature of and publicity given to this case and secondly because of the nature and extent of the rule breaches we have found. The next option is a public censure. Paragraph 12.3.3 of the Enforcement Manual gives guidance as to when public censure rather than a financial penalty is appropriate. Relevant considerations include the seriousness of breaches, the conduct of the firm after the contraventions were brought to its attention, FSA's approach in similar previous cases and the question of whether the firm has the means to pay a fine. We accept, as L&G forcefully submit, that a public censure in the financial markets is itself a significant penalty, but we do not adopt this option mainly because of the seriousness of the breaches and of FSA's approach in cases of similar gravity which has been to impose a financial penalty.

4. Chapter 13.3 of the Enforcement Manual sets out "*factors relevant to determining the appropriate level of financial penalty*" and states at 13.3.1(1) "*FSA will consider all the relevant circumstances of a case when it determines the level of financial penalty (if any) that is appropriate and in proportion to the contravention in question*". FSA avoids a tariff of penalties because the circumstances of cases are different and policy should be flexible and proportionate. Chapter 13.3.3 lists the factors which "*may be relevant*". Like the parties we have found those factors helpful and deal with each in turn.

5. **Seriousness of the contraventions**, including their duration and frequency, whether the contravention revealed serious or systemic weaknesses or had an impact on the orderliness of financial markets and public confidence in those markets as well as the risk of loss caused to consumers or other market users.
FSA emphasised that the breaches concerned the sale of low cost endowment policies used to repay mortgages often for relatively substantial sums and what for many of those consumers in this category would have been the most significant financial transaction in their lives. The breaches continued over a three year period (although limited to 21 months as regards evidence of any mis-

selling). Our conclusions about L&G's procedures revealed two significant weaknesses which, as we saw it, resulted in a real possibility that a customer would not understand and appreciate the capital shortfall risk. L&G were warned about some of these procedures and for some time took no adequate steps to address them. L&G are a very large business with a considerable number of customers and had some 41,000 policyholders exposed to the risk of loss.
Against this L&G point out that our findings about the extent of the breaches concerning procedures were more restricted than those of FSA in the Decision Notice and that we had attached significance to PIA approval of the wording of the PFR form (as opposed to the way in which it was used). L&G also remind us that FSA itself did not see the use of sample wording as being particularly serious and that agreement had been reached to resolve these breaches to an agreed time scale and apparently to FSA's satisfaction. L&G also point out that the mis-selling case failed except to the limited extent we identified at paragraph 205 of our Decision.

6. **The extent to which contraventions were deliberate or reckless**. This is not alleged.

7. **Financial resources of the firm**. These are obviously very substantial.

8. **The amount of profits accrued or loss avoided**. This is not relevant.

9. **Conduct following the contravention**. FSA accepts that L&G cooperated with its inquiries but not that it gave "*extensive, proactive cooperation*" so as to attract some discount to the penalty. FSA accepts that L&G agreed in October 2003 to undertake a complaints based review but contends that this should have been more prompt and effective. FSA also accepts that L&G changed their procedures in the course of 1999 and then stopped selling the products altogether. FSA complains however of L&G's continued assertion that their procedures were adequate and compliant and submits that this has had a real impact on customers. This assertion appears to have ceased since September 2004 and on 11th March 2005 L&G informed FSA that in the light of our findings they will review all complaints made as part of the complaints based review. When imposing a penalty we are proceeding on the assumption that L&G will carry out what they have undertaken to do.

10. **Disciplinary record and compliance history**. The evidence at the main hearing was that L&G's compliance history is better than average. A penalty imposed in 1994 is in our judgment irrelevant and FSA does not argue otherwise.

11. **Previous action taken by the FSA over similar behaviour by other firms**. The policy is that such previous action is clearly a relevant factor. FSA emphasises however that there may be other relevant factors which could increase or decrease the seriousness of the contravention.

12. We have been provided with helpful information about a range of cases. The most relevant of these are Abbey Life Assurance Company Limited (Penalty – £1 million), Scottish Amicable Life Plc (Penalty – £750,000) and Royal & Sun Alliance Life & Pensions Limited (Penalty – £950,000) and also, in a somewhat different context, Bank of Scotland (Penalty – £750,000). All these cases have some similarities with this one but many more differences. They were or may have been also the product of negotiation. None of the cases came before this Tribunal. FSA argues that these cases reflect a discount for full cooperation. L&G point out that none of them have the same mitigating features which they identify in this case. The particular features of all these cases have been helpfully identified in the materials given to us and we bear them in mind.

13. The parties agree that the original penalty imposed by the RDC, £1.3 million reduced to £1.1 million, is irrelevant.

14. L&G earn no discount as some companies have in other cases for promptly acknowledging fault. However L&G acted reasonably in contesting charges some of which we have found to be misconceived.

15. L&G submit that the publicity given to this case and in particular that resulting from FSA's press release after our Decision was published, should be taken into account given the damage said to have been done to L&G's "*brand*". FSA points to the publicity generated by L&G's own public relations effort and says this issue is irrelevant. We agree. What seems to us to be the inevitable consequence of any public proceedings should not mitigate penalty particularly in circumstances when we are not convinced that L&G's brand has suffered by this exercise.

16. We consider that in this particular case *"all the relevant circumstances"* should include to a limited extent the shortcomings in the FSA process. FSA informs us that the administrative process to which we refer below is adopted in disciplinary matters to promote informality and swiftness of decision. But this case has been neither informal nor swift. It has been a very long lasting and prodigiously expensive affair. FSA's investigation began in July 2000. Its Decision Notice was issued in October 2003. L&G have contributed their share to the delays and complications but, as we observe at paragraph 212 of our Decision, the primary responsibility for what has gone wrong rests with FSA. Moreover the RDC process was also unsatisfactory in the respects we mention when dealing with costs below. In addition FSA's decision to revive before the Tribunal the "*extrapolation point*" which the RDC had wisely dropped was, although permitted by the Rules, an unnecessary waste of resource.

17. The Tribunal has two paramount concerns when imposing a penalty. The first is that the rule breaches we have found should have now ceased. They have. The second is that all customers who have, or may have, suffered loss as a result of those breaches will be compensated. We have to rely on L&G's assurances and FSA's vigilance for that.

18. The factual basis for the penalty we impose is set out at length in our Decision. We do not repeat it here. The breaches were significant and persistent although less serious than alleged by FSA. Further, FSA's mis-selling case largely failed. The breaches were mitigated to a degree by FSA's own approach at the time, but compliance remained the responsibility primarily of L&G. Even so, L&G were a major supplier of low cost endowments and, with others in the industry, the cause of unnecessary loss, risk of loss and anxiety for borrowers. The financial penalty should be substantial. We have paid careful regard to all the factors set out in our Decision and in the written submissions and to what has been argued to us by Counsel. In light of all those considerations we will direct the FSA to impose a financial penalty of £575,000 (five hundred and seventy five thousand pounds) upon L&G (see section 133(5)FSMA).

C. COSTS

19. Each side generally pays its own legal costs when a case is brought before this Tribunal. FSA does not seek payment of its legal costs. L&G do seek these from FSA under paragraph 13 of Schedule 13 of FMSA. This provides:–"*(2) if, in any proceedings on a reference, the Tribunal considers that a decision of the Authority which is the subject of the reference was unreasonable it may order the Authority to pay to another party to the proceedings the whole or part of the costs or expenses incurred by the other party in connection with the proceedings".*

20. We have received able submissions from both sides about the approach to this Paragraph. In our view the words used are expressed in ordinary language and it is for us to judge whether a

decision (which, on a reading of paragraph 13 as a whole includes part of an overall decision) is unreasonable. It would be unhelpful for us to suggest a more elaborate approach coloured by the particular facts of this Decision.

21. L&G rely mainly on Decision paras 207-214 which we now set out again as without the text what follows will be unintelligible.

The Further Decision Notice ("The Notice")

207. The Notice must be read as a whole but we identify particular passages.
In its summary at 3.2(c), FSA concluded that "*the size and nature of L&G's business meant that these failures had the potential to expose a large but, as yet, unquantified number of consumers to loss. The FSA has concluded within a limited sample of 250 customers that the rate of mis-selling among the 152 respondents was 39%*".

208. At 3.16 the RDC referred to PwC's conclusion that "*there was persuasive evidence that they **were*** (L&G emphasis added) *risk averse and/or did not understand the capital shortfall risk associated with with-profits FMPs*". The paragraph goes on "*FSA has concluded that these customers **were*** (L&G emphasis added) *sold policies that were unsuitable for them and considers this to be a significant proportion of the customer's review*". At 4.18 the RDC repeated PwC's conclusions and added "*the FSA has concluded that this evidence is substantiated*".

209. In 3.17 the RDC refers to L&G's refusal to accept PwC's conclusions and adds "*In all the circumstances, particularly the time that has already elapsed and L&G's approach to the question, the FSA has not considered an extension of the sample review to be a realistic proposition. It has, therefore, been obliged to rely on the sample review as being strongly indicative of the potential consequences of L&G's selling practices and has arrived at its conclusions accordingly*".

210. L&G criticise the editing of PwC's report in paragraphs 3.16, 3.18 and 4.25. PwC actually said *"there exists persuasive evidence for a judgment to be formed on whether the customer was risk adverse and/or did not understand the capital shortfall risk and **may*** (L&G emphasis) *therefore have been sold a policy that was not suitable for them"* and *"it is our opinion that there is persuasive evidence to indicate that the policyholders were risk adverse, and/or did not understand the capital shortfall risk and **may** (L&G emphasis) have been sold a policy that was unsuitable for them"*.

In answer to a specific question from L&G's Counsel about FSA's conclusion that the 60 customers were sold policies that were unsuitable for them. Mr Chapman replied *"it is not the PwC conclusion"*. Mr Chapman explained that *"the reason I have said may is because, as I have described throughout the report with the passage of time, with the difficulties of getting information from a sale where we were not present so we cannot understand the absolute dialogue between the adviser and the investor, I would not give an absolute opinion and say: these have been mis-sold"* and that the report had used *"deliberately worded language which tried to convey the balance of judgments."*. FSA has not sought to justify its references in the Decision Notice to the PwC Report which were worded in stronger terms than PwC itself adopted. If, as we assume it to be, this was an oversight it was unfortunate. It suggests a lack of accuracy and may have been part of what led the members of the RDC to conclude that the 60 sales were unsuitable.

211. L&G say that the RDC's conclusions are supported by no further evidence at all. FSA submits that in reaching this particular conclusion "*the RDC had the benefit of evidence in relation to the deficiencies in L&G's procedures*". As we see it there is no indication in the Decision Notice that, on the question of mis-selling, the RDC relied on anything other than PwC's report. Indeed there are indications that the report was the entirety upon which the RDC relied ("*FSA has concluded that this evidence is substantiated*" - 4.18). As FSA is obliged by Section 388 of the Act to give reasons for its decision it seems to us that the RDC would have referred to other evidence if it had had this in mind. The RDC appears to have found L&G guilty of mis-selling by adopting the PwC report which PwC readily accepts did not of itself establish guilt or claim to do so. This appears to have been a significant error.

212. L&G criticise the RDC for apparently presuming in 3.17 that the PwC sample was representative of all endowment sales to low risk customers because L&G rejected the PwC report, maintained that the ESR was unnecessary and did not accept that L&G's procedures were flawed. FSA then rejects doing an extension of the sample review as not being realistic in the circumstances and given L&G's approach to the *"question"*. We would not have taken FSA's position. It is for FSA to establish its case and produce the evidence it relies on. The existence of delays and what FSA may see as unreasonableness on the part of the party challenged are no doubt frustrating if not infuriating. They are not however a justification for reaching a conclusion that FSA is *"obliged"* to rely on evidence as being "strongly indicative" and arriving at its conclusions "accordingly". We see no such obligation. The issue should be - what is the evidence and what conclusions do we draw from it? If more evidence was needed FSA should have obtained it.

213. L&G also criticise the absence from the Decision Notice of any answer to L&G's submissions in its defence based on the risk warnings in the KFD and the personal illustrations. FSA replies that L&G's case had been made very clear on numerous occasions and in particular in the Investigation Report which it had disclosed to L&G to assist them to understand how FSA puts its case. We recognise that the RDC's Decision needs to be concise and to the point. The Decision Notice is not a judgment of a court and there are good reasons why it should not be. The RDC no doubt considered L&G's submissions and gave them careful consideration but there is no indication in the Decision Notice that they did. It is the experience of the courts, tribunals and many disciplinary bodies that it is useful for any judgment or decision to refer to the competing cases of the parties, if only in very brief terms. This has the benefit not only of reminding the tribunal of a party's submissions but also of later demonstrating to it that these were considered when decisions were taken.

214. In our view L&G were justified in feeling aggrieved by these aspects of the RDC's Decision. There are other criticisms by L&G of the RDC decision which seem to us to be immaterial or to relate to questions of a penalty. If these remain live we will deal with them at that point.

22. The heart of L&G's claim is that FSA Enforcement, and later the RDC, did not listen to L&G's case or reach a decision on the evidence. If they had there would have been no Decision Notice and the outcome would have been a Private Warning. Our Decision makes that position untenable. But L&G have a more powerful argument on the narrower question of FSA's approach to the mis-selling case.

23. FSA claims incorrectly that we "*never had the benefit of detailed submissions from the Authority*" - we had 11 pages of written closing submissions on the subject. We also now have the

written statement of Mr Christopher FitzGerald, Chairman of the RDC from July 2001 until June 2004, who chaired the Panel responsible for the Decision Notices in this case. L&G did not seek to cross-examine Mr FitzGerald and we take his statement to be truthful and accurate on the matters of fact with which it deals. He explained, amongst other things, the role of the RDC which, as we pointed out in our Decision, is not a court but what he describes as an "*administrative decision maker*". He points out that the RDC does not test evidence or adjudicate between competing cases although it must be satisfied that the evidence presented to it is sufficient to justify particular action. Before considering Mr FitzGerald's evidence about how the RDC reached its decision we summarise what the disclosed papers tell us of how the RDC decided the mis-selling issue.

24. The RDC Panel dealing with this case met on 16th April 2003 to consider an Investigation Report prepared by Enforcement (of which no criticism is made and which had been disclosed to L&G) and other relevant materials. These materials included a Case Review Paper prepared by the lawyers in Enforcement and not disclosed to L&G. The RDC approved a draft Warning Notice which was issued to L&G on 30th April. The Warning Notice imposed a penalty of £1.3 million and assumed that PwC's conclusion that there had been a 39% rate of mis-selling could be extrapolated and applied across L&G's business to produce about 9,360 unsuitable sales. It is also clear from the RDC Minute of 16th April that the 39% was compared, when assessing relative seriousness, with percentage failure rates in other cases. L&G submitted written responses to the Warning Notice on 14th June and 4th July. On 24th June Mr Chapman of PwC attended an L&G board meeting and expressed frank views. He said that FSA was on a mission against endowments where other firms had now set a precedent. He said that his firm's report did not suggest that there had been systemic mis-selling by L&G in the sense of anything deliberate and he explained that the 250 cases PwC had looked at were a very small sample and probably not enough to give a statistically valid basis for extrapolation. He also stated that FSA had not asked for his view on statistical validity. On 9th July the RDC met again, initially with L&G representatives who agreed to forward further information to FSA. The minutes (not approved until 31st March 2004) show that after L&G left the meeting the RDC discussed "*potentially a very significant*" point, the note of the meeting at L&G on 24th June "*which materially undermined the value and reliability of the PwC report*". PwC's remarks about extrapolation were seen to have been "*certainly unfortunate*" but not fatal to a reasonable conclusion that there was persuasive evidence of mis-selling. It could still reasonably be concluded from the PwC report that it was likely that a significant number of mis-sales had occurred and that that was sufficient evidence of the likelihood of breaches. The RDC decided to defer a decision until L&G's information had been received and assessed. "*The expectation*" was that L&G's additional information would provide more specific evidence of mis-selling and inadequacy.

25. L&G supplied the information on 23rd July 2003 and this was passed to the RDC on 31st July by Enforcement with a "*supplementary recommendation*" in effect that the same penalty of £1.3 million be imposed on L&G as had been set out in the Warning Notice. FSA has claimed privilege for much of this document but a section *"Revision of Penalty"* has been disclosed. Enforcement felt that "*certain of the material*" submitted by L&G confirmed the wisdom of the proposed penalty and that L&G's "*own data indicates serious problems*". The recommendation focused on a complaints uphold rate of 24.18% which in our view should not have been considered in isolation. If the "*material*" and "*data*" was that submitted by L&G on 23rd July we disagree with Enforcement that it indicates serious problems. This document was not seen by L&G.

26. At its meeting on 27th August the RDC Panel (see the Minutes, again not approved until 31st March 2004) adopted most of the recommendations of Enforcement. The Panel asked that Enforcement staff "*review certain of the existing underlying evidence and produce schedules which would reinforce the Panel's confidence in the work done by PwC and more clearly demonstrate that*

mis-selling of mortgage endowment policies had taken place." There was a hope that such material might persuade L&G executives to see things differently. FSA has also claimed privilege for the fruits of this request and neither L&G nor we know whether the schedules were produced or, if they were, what they said. It is however clear from a letter of FSA of 16th September that the RDC Panel were to receive "*additional legal advice*" but not "*fresh evidence*". The Panel had another meeting on 18th September. The Minutes (again not approved until 31st March 2004) indicated Board approval to the draft Decision Notice which was then issued on 25th September. As we pointed out at Decision para 181, the Decision Notice, unlike the Warning Notice, did not extrapolate and it considered only that the PwC evidence was "*indicative of a significant problem*".

27. Mr FitzGerald points out that this change was a careful and deliberate decision reached by the Panel as a result of what Mr Chapman had disclosed to L&G in June. Mr FitzGerald observes that the heart of the case was deficiencies in sales procedures, not actual mis-selling. Having found those deficiencies it was likely that mis-sales would also occur. He explains that when it came to mis-sales the RDC asked three questions. First were they satisfied that "*redress payable*" customers were risk adverse and/or did not understand the capital shortfall risk? Secondly, if so, were they sold unsuitable policies? Thirdly were these mis-sales? PwC's conclusion that "*persuasive evidence*" existed led the RDC to decide, on the balance of probabilities, that it was more likely than not that customers were indeed risk averse or did not understand the shortfall risk. The RDC was looking at all the material before it, including the views of PwC, KPMG and FSA Enforcement (even though it appears that Enforcement staff had not identified any actual mis-sales) and applied its judgment to reach a conclusion. Hence at 3.16 "*The FSA has concluded that these customers were sold policies that were unsuitable for them…*" It may be that this approach followed the advice of the lawyers in Enforcement which the claim to privilege has not enabled us to see.

28. L&G object to Mr FitzGerald's evidence. They also point to case law which emphasises the need for caution when reasons are put forward after the event which were not expressed at the time. Mr FitzGerald, on his account which was not challenged and which we accept, was explaining the RDC's reasoning at the time the Decision Notice was issued, not coming up with new reasons. L&G also put forward powerful arguments for suggesting that the approach adopted by the RDC was wrong. But this does not mean that their Decision was unreasonable. L&G also object to the absence of disclosure and to FSA's claims for privilege. L&G did not take forward their challenge to privilege but this did cause FSA to release material which it had at first held back.

29. The thrust of L&G's application concerns the reaction of FSA to Mr Chapman's views about extrapolation. Following that development the RDC considered matters carefully, reviewed the evidence, sought further legal advice and then issued a Decision Notice expressed differently from the Warning Notice. Mr FitzGerald's account is not challenged. We are considering not whether a court acted correctly but whether an administrative process was unreasonable. When dealing with a large volume of regulatory matters informally and speedily, FSA should not be expected or compelled to follow procedures, or to express its conclusions, as required of a court. We are puzzled that the financial penalty in the Warning Notice remained the same in the Decision Notice despite the evidence of mis-selling becoming obviously weaker in the interim. Nevertheless, having considered FSA's further evidence, the Tribunal is not satisfied that the Decision of FSA (despite the shortcomings in the process by which it was reached) was unreasonable and will not therefore order it to pay costs.

30. We remain of the view expressed in our Decision (Para 214) that L&G were justified in feeling aggrieved by the process by which the RDC's Decision was arrived at. Although the evidence of Mr FitzGerald has clarified certain matters, disclosure by FSA of other aspects of the decision making process gives rise to other concerns. Without the evidence of Mr FitzGerald the

Tribunal would have gained a different impression from the papers before it. The RDC should not have seen Mr Chapman's commendably honest and appropriate disclosure to L&G as "*unfortunate*". The papers, particularly those from Enforcement, seem more concerned with identifying reasons for maintaining the proposed sanction than with objective evaluation of a new development. The new data which arrived from L&G was in our view not as serious as Enforcement claimed it to be. Minutes of important meetings with serious consequences for L&G were not approved for months. The distinction drawn by FSA between what goes into the Investigation Report (which is disclosed) and what goes into the Case Review Paper (which is not disclosed and for which privilege may be claimed) seems a fine one, open to inadvertent abuse and an enemy of transparency. We are unmoved in this view either by FSA's submissions that this is what all regulators do or by the rule of law that no adverse inference can be drawn from a valid claim for privilege. It is still open to the Tribunal to point out that a process will not be transparent if part of it takes place behind the veil of privilege.

D. RECOMMENDATIONS

31. We referred in paragraph 21 of our Decision to our power to make recommendations under Section 133(8) of the Act. This was not a hint that we proposed to make recommendations but a description of the procedure we would adopt should either party ask us to do so. At the request of FSA we also omitted from our Decision a draft paragraph expressing what we understood to be common ground between the parties about the approach to adopt to communications about settlement involving FSA Enforcement, a Party and the RDC.

32. L&G asked us to make recommendations and to address, as we had said we would at this stage, the draft paragraph. On 2nd February 2005 FSA announced a Review of its Enforcement processes. This led us to suggest at the hearing on 21st February that it might not be useful or productive for us to make recommendations. That view is strengthened now that we have seen details of the proposed Review. In the course of our Decision and this Further Decision we have expressed views about this particular case which may or may not be relevant to the Review. If however the Tribunal is to contribute to that review with more general recommendations, those should come through its President who can draw on the experience of other cases as well as this one. As FSA is now conducting a Review of its enforcement processes we will make no formal recommendation in this case.

CONCLUSION

33. The Tribunal directs that :

(a) The FSA shall impose a financial penalty of £575,000 (five hundred and seventy five thousand pounds) upon L&G (see section133(5)FSMA).
(b) There will be no Order for costs.
(c) The Tribunal will make no recommendations under Section 133(8).

JUDGE DAVID MACKIE CBE QC

CHAIRMAN

FIN/2003/0022