

CODE OF PRACTICE

**Best practice requirements from the European Life Settlement Association
(ELSA)**

July 2010

Edition 1.0

PAGE OF CONTENTS

Foreword	3
A. Asset origination	5
A1. Policy sourcing	5
B. Asset and risk management	6
B1. Product structure and management of counterparty risk	6
B2. Mitigation of longevity risk	9
B3. Mitigation of liquidity risk	11
C. Managing the investor relationship	12
C1. Education	12
C2. Marketing literature and disclosure	13
C3. Distribution and ongoing communication	15

FOREWORD

The European Life Settlement Association (ELSA) Code of Practice has been introduced to establish common standards of best practice within the European life settlement industry and protect the interests of investors in the asset class.

The growth of life settlements, including the expansion of these investments into the retail market, has rightly heralded a greater degree of regulatory and market scrutiny. Greater education and engagement with the needs of the wider market is essential in this environment to ensure the suitability of investments backed by life settlements for prospective investors to whom they are recommended. This engagement will prove crucial in winning the battleground for investor choice while also ensuring the reputation and professionalism of the asset class and the protection of investors.

The industry has been swift to point out the advantages of investing in life settlements – namely the asset's low correlation with the main markets, and ability to provide a stable source of income and/or capital growth. However, it has been slower to develop best practice and help impartially inform the understanding of investing in this asset class. Now is the time for the industry to come together and communicate exactly what 'quality' looks like, and set in place standards that will ensure this information is made available to all. In so doing, it is essential that those advising and committing capital to life settlement investments fully understand the asset class, including the risks.

The members of ELSA hold a passionate belief, borne out of many years of working within the industry, that this is an asset that provides real value to investors. Access to genuine diversification from correlated investments and the market risk they pose is both rare and compelling. Nonetheless, this is a structured asset with particular risks and complexities, and those benefits will *only* be enjoyed if the asset is structured, managed and serviced appropriately. For investors, knowing exactly what to look for can prove difficult in light of this complexity. Product failures, such as those at Shepherds and Keydata, act as cautionary tales where, to the naked eye, investors and advisers believed in those investment structures and the security of the underlying assets.

Let us be clear: there *are* particular asset risks relating to life settlements: namely, those of longevity and liquidity. The number of third parties connected with a given investment structure also brings an added layer of complexity. The central issue for investors relates to the structuring of these kinds of investments – in short: how they can be made more transparent for investors, and how the particular asset risks are managed and mitigated through conservative asset management.

It is essential that the understanding is in place for investors and advisors to understand these processes more deeply, and that industry practice is such that the managing and servicing of the asset results in the kind of performance anticipated. The detailed guidance provided by this Code is therefore intended not only to provide assurance about the operations of firms that subscribe to the practices detailed herein, but to help inform those assessing life settlements so they understand more clearly what precisely they should evaluate. In producing this Code, ELSA is seeking to engage with all those offering

life settlements, across the wholesale and retail spectrum, to influence behaviour and bring greater transparency to these investments in the market at large.

A Code of this sort is, by its nature, principles-based in style. However, the breadth and scope of this document and the provisions relating to financial communication, record-keeping and management information, are such that ELSA is confident in its merit for helping to identify quality market participants, and ensuring that those who subscribe to the Code are constantly focused on the needs of investors and the management of the asset. This is an international industry, and thus the Code seeks to bring greater standards to the industry at large for which there is a substantial European investor base. Domestic regulation can, by its nature, have only a more limited reach. The creation of the Code is intended also to provide an effective self-regulatory function to what can otherwise be a difficult investment area to assess.

The Code takes on board existing international guidelines, as well as consultation with the industry, other market participants and national financial regulators. All ELSA members must comply with it;¹ only by doing so will they and the Association be recognised as promoting the highest professional and ethical standards in the industry.

The Code is a living framework, intended both to encourage and reflect the development of the European life settlement industry in the years ahead. As the market continues to mature under its guidance, it will be continuously monitored and periodically updated to ensure that it continues to best serve the needs of the life settlement investor.

Anna M. Bailey
Chair, ELSA

¹ Failure to comply with the code will result in suspension and ultimately expulsion from the Association.

A. ASSET ORIGINATION

A1. Policy sourcing

Main principle

Members of the Association will ensure the protection of investors by engaging with trusted partners and conducting their business appropriately throughout the product lifecycle.

Supporting principles

When sourced appropriately, life settlements provide a welcome means for US senior citizens to free up the inherent value of an unwanted life insurance policy, where the alternatives of allowing a policy to lapse or surrender are highly unattractive.

The same types of protection afforded by the regulatory structure to US policysellers must be replicated for the end investor. The investor must receive fair value and best execution in the acquisition of those policies.

It is the responsibility of those providing life settlement backed investments to ensure that the entire process, including the sourcing of the asset, is such that it provides the greatest value to investors.

Provisions

- A1.1 Members who are in a dominant position in the industry shall not take advantage of their position by engaging in practices that could be deemed harmful to competition, and should work towards the creation of an orderly market.
- A1.2 Members shall comply with the governing laws and regulations regarding origination and will always source policies in a manner consistent with them. In particular, members shall only deal with providers who, in each and every purchase in a US state that requires a license, actually have a license to originate policies in that US state.
- A1.3 Members will not purchase policies that they believe were issued without valid insurable interest at policy origination, or where the member has grounds to believe that the information provided in the policy application was false or misleading.
 - A1.3.1 Members must have in place records management processes and relevant management information that reflects the quality and validity of that policy origination.

- A1.4 Members should, both in their marketing literature and their discussion with managers and intermediaries connected with the sale of these investments, provide detail about the methods and transparency of the policy acquisition process.
- A1.4.1 In this, they should disclose the name of the company or companies responsible for the provision of those policies, making clear why they choose to partner with them and their standing in the market.
- A1.5 Those providing life settlement backed investments will ensure that the fund or product structure is subject to independent valuation aside from any due diligence undertaken by the entity responsible for sourcing the policy.
- A1.6 Members shall not purchase policies that were directly or indirectly transferred during the policy contestability period unless:
- A.1.6.1 The transferees all had an insurable interest in the life of the insured; or
- A.1.6.2 Such policy was settled pursuant to an exemption set forth in the applicable US state's life settlement laws.
- A1.7 If the US state does not have laws of this sort pertaining to insurable interest, then the policy should only be purchased if such a policy was settled pursuant to an exemption set forth in the NCOIL Life Settlements or NAIC Model Viatical Settlement Acts².
- A1.8 Members shall not purchase premium financed policies without disclosing the potentially-increased insurable interest risk associated with some premium finance programs.
- A1.9 Members will demonstrate their commitment to privacy, and develop and implement procedures that are designed to protect the identity of the policyholder so as to prevent inappropriate disclosure of individually identifiable confidential information.

B. ASSET AND RISK MANAGEMENT

B1. Product structure and management of counterparty risk

² For the purposes of those unfamiliar with life settlements, the industry of traded life policy investments (TLPIs) consists today mainly of 'senior' life settlements – policies relating to senior US citizens over the age of 65 – and a smaller amount of viatical settlement investments. Viatical settlements refer largely to the original TLPIs from when the industry emerged in the 1980s, which involved policies of the terminally ill. As a result of this heritage, some of the legal framework pertaining to TLPIs makes reference to viaticals.

Main principle

Members of the Association shall ensure clear and prominent disclosure of counterparty and third-party risk and have robust systems and controls in place to mitigate this risk to best effect in the structure of investment products.

Supporting principles

It is the responsibility of those providing life settlement backed investments to ensure due explanation is given in their marketing literature – and other materials and communications – to advisers, managers and intermediaries about counterparty and third-party risk.

Counterparty risk relates to potential carrier solvency – in short, that of US life insurers underwriting the policies. Third-party risk is that posed by the various asset servicers involved in the asset acquisition, servicing and valuation processes. Proper care must be taken throughout the course of the investment to ensure that investors are not exposed to unnecessary risks pertaining to third parties that were in the power of product providers to anticipate and pre-empt.

Provisions

- B1.1 Counterparty and third-party risk must be explained to investors in a clear manner and given appropriate prominence in promotional material.
- B1.2 Such material should include clear descriptions of the specific roles, responsibilities and experience of all asset servicers in the financial structure. Roles and responsibilities must not be described in a manner which could mislead the investor, and all fees paid to the asset servicers should be disclosed.
- B1.3 The names of all third parties connected with a given product should be listed in marketing materials pertaining to the investment product or structure. If third parties are in any way connected to other third parties or to the member – through an informal partnership or affiliation, or more officially such as in the case of a sister organisation or subsidiary – this relationship must be clearly highlighted to investors.
 - B1.3.1 If any company or companies connected with the investment process or structure are beneficiaries of compensation through performance fees or other incentives, these mechanisms must be clearly and prominently explained in marketing and product literature. This is to ensure that investors' interests are aligned with the product structure and they understand the product into which they are investing.
- B1.4 If the third parties connected with a given product change, advisers, managers (or in the case of the retail market, financial advisers), should be informed in an appropriate communication in an accurate and timely manner.

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- B1.5 Members must ensure that investors' assets are appropriately isolated, in independent custodian trusts, to ensure they are protected. By 'independence', there should be no legal connection between those entities, or the ownership of those entities, involved with the vital functions of valuing or holding the underlying asset. If there is an overlap between these parties, this relationship must be disclosed – ideally naming key individuals. It is the responsibility of members to ensure that investors are in a position where they are able to validate and verify the quality and independence of third parties connected with a given investment product.
- B1.6 Should the ownership of those responsible for the safe custody of assets change after the point of sale, this should be communicated to investors in an accurate and timely manner over the life cycle of the product.
- B1.7 Members should ensure that the investment structure provides for independent audits at regular intervals, at least annually, to confirm the existence and maintenance of proper records and the safe custody of assets.
- B1.8 Members will report to advisers, managers (or, in the case of the retail market, financial advisers) on a monthly basis on the performance of the investment to include:
- B1.8.1 The number of policies currently held, with reference to the means by which diversification has been achieved for investors taking into account the following:
 - B1.8.1.1 Policy volume;
 - B1.8.1.2 Size of policy;
 - B1.8.1.3 Average mortality factor;
 - B1.8.1.4 Geography of the insured;
 - B1.8.1.5 The number of insurers;
 - B1.8.1.6 Gender of the insured;
 - B1.8.1.7 Age of the insured; and
 - B1.8.1.8 Life expectancy distribution;
 - B1.8.2 Information pertaining to policies matured and how these have performed against initial life expectancy forecasts, while noting that actual versus expected analysis only has value after a sufficient amount of time has passed. This should also include information on policies that have not matured in line with life expectancy forecasts and provide a statement on the overall financial health of the vehicle with respect to anticipated performance;
 - B1.8.3 The cash position of the investment structure: that intended for future policy acquisitions, payment of ongoing premiums and any cash buffer contained within the structure to meet any other ongoing cash outflows. In particular, a report should be generated that states the expected time-period until an insolvency event would occur, assuming no new cash flow was committed to the product;

- B1.8.4 A clear statement conveying the extent to which the investment as a whole is, or is not, performing in line with expectations. Should the investment provider have knowledge that investment returns will be lower than likely returns indicated at the point of sale, this should be disclosed to the investor in an accurate and timely manner as well as included in this periodic document on the performance of the structure; and
- B1.8.5 (Retail market only) A quarterly statement – signed off by the entity responsible for the handling of structures for tax-efficient investment such as ISA inclusion – confirming the appropriate handling of the investment³.
- B1.9 Members will disclose to investors all fees and commissions payable to financial advisers and/or all distribution channels between the investor and the funding entity. Any performance-related or other fee whose basis, expected size or expected timing is not obvious should be illustrated by way of example.
- B1.9.1 Mark-to-model valuation should not form the basis of excessive or generous performance fees, in that there is a clear danger in paying substantive fees on expected, rather than actual, performance. Members should consider the levels of fees involved, the value to investors, and whether or not it is useful to put in place a claw-back measure should investments not perform as expected.
- B1.9.1.1 Both the way in which performance fees are generated, and the value and reasoning, must be clearly disclosed to investors in marketing material and product factsheets, in a way that is prominent and plain-speaking. The triggers for those financial incentives must be meaningfully explained in plain language.
- B1.10 Members will undertake a due diligence exercise on all third parties connected with the investment structure prior to inception of the fund and will monitor performance closely over the lifecycle of the investment. They should generate and evaluate relevant management information in connection with this exercise, and as part of a formal due diligence evaluation on a yearly basis.

B2. Mitigation of longevity risk

Main principle

³ An ISA or Individual Savings Account is a popular UK financial product, designed for the purpose of encouraging savings and investment by creating a tax-free wrapper around certain cash and investment products.

Members of the Association shall ensure effective controls and valuation models are in place in order to try and mitigate to best effect the risk posed by increased life expectancy of the insured.

Supporting principles

It is the responsibility of those providing life settlement backed investments to ensure that product structure, partners and life expectancy analysis are all such that the targeted returns promoted to investors are fair assumptions based on current life expectancy projections.

Provisions

- B2.1 The risks pertaining to longevity must be explained to investors in a clear manner and given appropriate prominence in promotional material.
- B2.2 A clear explanation of how that risk is mitigated to best effect by the investment structure will be included in the marketing literature pertaining to the investment structure. For example, this may be through policy diversification, a cash buffer, or through other mechanisms, providers or funding entities put in place in order to try and smooth potential volatility of returns due to longevity risk. If no liquidity facility is to be deployed, the material should clearly explain why this is not required.
- B2.3 A clear explanation will be given regarding the investment strategy for dealing with unforeseen additional premium payments as a result of longer life expectancy or increases in the cost-of-insurance charged by the life insurance company, in particular highlighting clearly whether the responsibility falls to the provider or the investor and how returns will be impacted:
- B2.3.1 This should ideally be given a graphical representation to make clear to investors the impact on their capital in various scenarios of increased life expectancy;
 - B2.3.2 A clear statement regarding the risk of an increase in the premium payments applicable to policies due to prospective adjustments by a life insurance company;
 - B2.3.3 A clear statement applicable to any hedging position or longevity insurance owned by the structure including the maturity date, claims experience (if any), maximum claim amount, exclusions, and a full disclosure of the credit rating of the counterparty offering the hedging position or longevity insurance; and
 - B2.3.4 A clear statement applicable to any financing facility supporting the structure including the loan terms, maximum lending, repayment provisions (timing and seniority), conditions of default, and the credit rating of the counterparty providing the liquidity.

- B2.4 It is essential that conservative life expectancy analysis underpins the basis of the product or investment structure. Investment managers must clearly outline and explain the rationale for their life expectancy methodology in marketing materials, making reference to:
- B2.4.1 The number of life expectancy (LE) providers deployed;
 - B2.4.2 The mechanism by which life expectancies are averaged or otherwise combined within the methodology; and
 - B2.4.3 The scenarios in which exceptions to this methodology may be made, if any.
- B2.5 It is the duty of the investment manager to design an objective life expectancy methodology that eliminates or significantly reduces the possibility of discretionary discarding of unfavourable life expectancy estimates.

B3. Mitigation of liquidity risk

Main principle

Members of the Association shall ensure the investor is not exposed to unnecessary liquidity risk, beyond that reasonably posed by the character of the underlying asset.

Supporting principles

It is the responsibility of those providing life settlement backed investments to create checks and balances so as to monitor the liquidity and health of the investment structure. In so doing, they must consider what controls to implement within the investment structure to mitigate to best effect the risks posed by liquidity, and consider the effectiveness of those controls for their target investor base – taking into account the likely risk/reward appetite of those targets.

Provisions

- B3.1 The risks pertaining to the relative liquidity of the asset must be explained to investors in a clear manner and given appropriate prominence in promotional material.
- B3.2 Due to their low market correlation, life settlements have the potential to provide not only asset diversification for investor portfolios but also less volatile returns. Providers or funding entities of these structures must ensure that in explaining this advantage with respect to volatility, they do not underplay the relative illiquidity of the asset itself.
- B3.3 Investment providers or funding entities should clearly explain in supporting product literature the liquidity of the investment structure and the asset valuation process due to the relative illiquidity of the asset itself:

- B3.3.1 How asset values are calculated at purchase and how asset valuations are maintained throughout the life of the investment;
- B3.3.2 How assets will be serviced, including the facilitation of ongoing premium payments and the tracking of insureds;
- B3.3.3 How the product structure operates in the event of early redemption by the investor, including any charges imposed for withdrawing capital at various points within the investment term;
- B3.3.4 The controls that are in place to attempt to mitigate liquidity risk, such as holding excess cash or policy within the structure. Where there is no such mechanism, investors should be clearly informed in the body text of product literature that the risk relating to liquidity is managed solely through policy selection and that the risk of assets not performing in line with targeted returns is with the investor; and
- B3.3.5 How the product structure would perform in the unlikely event of forced short-sale of the asset.

C. MANAGING THE INVESTOR RELATIONSHIP

C1. Education

Main principle

Members of the Association shall promote life settlement investments as part of a well-balanced portfolio and promote the sale of products that match the risk/return profile of prospective investors.

Supporting principles

It is the responsibility of those providing life settlement backed investments to conduct their business at all times with integrity, in a manner consistent with the interests of investors. This requires them to take an active role in the continued education and provision of information to investors, including after the point of sale.

Provisions

- C1.1 Members offering life settlement backed investments will monitor developments that affect investors, in the market at large and with respect to their own investment structure. They will

inform investors in writing if they are directly affected by any such developments, and in an accurate and timely manner.

- C1.2 When existing investors are only indirectly affected by changes in industry practice, they should also publicise this information, in an appropriate form.
- C1.3 Members shall recommend that investors retain their own independent professional advice in connection with their investment.
- C1.4 Members should not knowingly conceal information from the investor which would potentially affect their decision whether or not to invest. In circumstances where information is withheld to comply with a specific regulatory requirement – for example, it would be in breach of privacy laws to reveal the identities of policyholders – investors should be informed in writing, and a reference to the relevant regulation included.

C2. Marketing literature and disclosure

Main principle

Members of the Association shall provide marketing material and communications to investors that are clearly directed at target investors to help ensure the suitability of the subsequent investment made into life settlements.

Supporting principles

It is the responsibility of those providing life settlement backed investments to produce, in the words of UK regulation, material that is 'clear, fair and not misleading'.

In the case of life settlement related marketing material, product literature must deal effectively with the complexity of the asset and the number of partners involved.

In addition to the above provisions – particularly those relating to disclosures concerning third parties connected with the investment structure – the following provisions are required to ensure that marketing literature is structured and evaluated so that it is effective in furnishing useful information to investors.

Provisions

- C2.1 Members will generate management information on at least a six-monthly basis from advisers (retail) or investors (wholesale) to ascertain the effectiveness of their literature. In particular, this information should probe investors' understanding of the product returns, their understanding about any potential threat to capital, and their understanding about the risks pertaining to life settlement investments more broadly.

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- C2.2 Members will also use this exercise to evaluate the audience to which these investments are made available and map that to the intended target audience for the investment structure.
- C2.3 Investment managers will ensure that due prominence is given to the risks as well as the benefits of investing. In particular, they will ensure that:
- C2.3.1 Font size is equal or such that it does not discourage or mislead the investor;
 - C2.3.2 The risks are carried in a suitable part of the document – be that within the initial pages of marketing material or given adequate context throughout marketing literature, which then clearly and meaningfully directs the investor to the area that covers risks in full;
 - C2.3.3 The language and tone used is consistent with that of the remaining material to ensure continued simplicity. In this members may, for example, wish to consider consumer-friendly formats, such as Q&A or pictorial representation, to make clear the way in which the investment could perform with regard to the risks affecting that performance;
 - C2.3.4 Representative life expectancy scenarios are presented to the investor, and the way in which increased life expectancy would likely affect returns. In particular, if calculations reflect a gross rate of return rather than that generated for the investor, this should be clear in any graphical representation and accompanied by an indication of likely investor returns; and
 - C2.3.5 If reference or promotion is given to the number of policies held within a portfolio, they indicate the number of lives to which the portfolio has exposure, and vice versa. Highlighting both the number of policies and the number of lives ensures that investors are clear as to the real extent of portfolio diversification since, depending on the risk being considered, the unit of risk may either be a policy – e.g. insurer credit risk – or a life – e.g. longevity risk. Specifically:
 - C2.3.5.1 If multiple policies are held on the same insured life, the number of distinct lives must be highlighted and not just the number of policies; and
 - C2.3.5.2 If policies are held that relate to multiple insured lives – e.g. ‘joint life’ or ‘survivorship’ policies, which depend upon the mortality of more than one life for maturity – the number of distinct policies must be highlighted and not just the number of lives.
- C2.4 Members will include stress-test scenarios within their literature to make clear the typical circumstances under which it will and will not deliver according to targeted returns.

- C2.5 Synthetic structures, such as derivative-backed instruments linked to indices of lives, place an additional burden on Members with regard to education and risk analysis. Even though some synthetic structures may remove certain risks related to the ownership of the physical asset – e.g. insurer credit risk – they may introduce others of equal or greater magnitude – e.g. counterparty credit risk.

C3. Distribution and ongoing communication

Main principle

Members of the Association shall put in place systems and controls that will allow them to monitor effectively the distribution channels through which they make their products available, for the protection of the investor.

Supporting principles

It is the responsibility of those providing life settlement investments to create checks and balances to ensure that they do everything within their control to ensure the distribution chain is as strong as possible.

While much of the following distribution chain provisions will necessarily be applicable to the retail investment market, unless otherwise specified this holds true for the sale of all life settlement backed products which are not sold directly from the investment the provider or funding entity to the investor.

Provisions

- C3.1 Members will implement controls to ensure partners do not abuse the trust placed in them for personal gain. They should ensure that investors are not put under pressure by affiliated third parties that might influence their decision to invest.
- C3.2 They will ensure that any third parties distributing their products are provided with adequate material and education to sell their products correctly.
- C3.3 Members will gather, analyse and act on appropriate management information regarding the way their products are distributed to minimise the risk of products being mis-sold, inadvertently or otherwise. This should include:
- C3.3.1 The number of sales made by the distribution partner. For major partners, the provider or funding entity should agree a regular meeting schedule to assess:
 - C3.3.1.1 The pattern of sales;

- C3.3.1.2 The material used in the investment process and to take feedback from distributors;
 - C3.3.1.3 The typical profile of enquiries and end-investors committing funds; and
 - C3.3.1.4 Establish whether any further material is required to help support the investment process responsibly and the typical profile of investors. Members should respond in an accurate and timely manner to any enquiries for further information to help support the education and responsible sales efforts of advisers;
- C3.3.2 An indication of the amount of capital committed by the investor. The provider or funding entities must stress to partners that life settlements constitute an asset class that enables diversification and that the percentage of investor money committed should be a fair reflection of that diversification. Life settlements should not comprise a significant percentage of an individual investor's portfolio;
- C3.3.3 Regular assessment of that management information. It is the duty of the provider or funding entities to review at regular intervals the management information they are generating and act on it accordingly. In particular, they should question above-average capital investment via a distribution partner, and above-average volumes of sales;
- C3.3.4 (Retail market only) Mystery-shopping exercises. The provider or funding entities should, on at least an annual basis, contact end-investors to assess their satisfaction with the investment's performance and overall understanding of the structure; and
- C3.3.5 Management information relating to any dissatisfaction and with regard to investor understanding should be generated, to create a feedback mechanism to inform adviser training, marketing material and other educational provision.
- C3.4 Members who are product providers will sell directly only to professional clients and not directly to the retail investor. Should members be approached directly by an individual investor, they may provide basic information about their investment offering but will request investors seek independent professional advice before committing funds.
- C3.5 In literature aimed at the retail investment market, full disclosure of all third parties connected with the investment process will be listed, to allow advisers or end-investors to verify to their own satisfaction the quality of third parties attached to the investment product.
- C3.6 Members will inform distributors of how regularly they undertake due diligence of those third parties and set out in a convincing manner the way in which they separate the powers of those servicing the asset so as to ensure its safe holding. Advisers will be encouraged to ask for a

report from the provider or funding entity that sets out this separation of powers in a convincing manner.

C3.7 In addition to the accurate naming and disclosure of parties connected with the investment structure (please refer to section A), the following regular reporting will also be made available on a yearly basis:

C3.7.1 A report on the yearly audit valuation given to the investment structure, and a statement detailing the extent to which the fund is performing as expected and with regard to any cash buffer (additional liquidity) remaining within the fund should it not perform in line with expectation. Taken together, the audit and statement help improve communication and expectation over capital return, and mitigate the risk of there being insufficient proceeds from matured policies to cover that capital return.