PROHIBITION ORDER – Fitness and propriety – Involvement of Applicant in financial reinsurance – Legitimacy of transactions – Integrity and recklessness – Reference dismissed

FINANCIAL SERVICES AND MARKETS TRIBUNAL

MILAN VUKELIC **Applicant**

- and -

FINANCIAL SERVICES AUTHORITY **The Authority**

Tribunal: HIS HONOUR JUDGE MACKIE CBE, QC
MS SANDI O'NIELL
MR IAN ABRAMS

Sitting in public in London on 1-9 December 2008 & 13 March 2009

Mr Charles Flint QC and Mr Andrew Green, instructed by Norton Rose, for the Applicant and Mr James Bagge of Norton Rose, appeared for the Applicant on 13 March

Mr Guy Philipps QC and Mr Dan Enraght-Moony, for the Authority

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DECISION

5 1. The Applicant, Mr Vukelic, challenges a decision by which the Financial Services Authority ("the Authority") prohibited him from, in effect, working in regulated financial services activity following his involvement in three sets of transactions involving financial reinsurance. At the heart of the case are the nature, effect and probity of those transactions and Mr Vukelic's responsibility 10 for them. Mr Vukelic says that these were legitimate financial reinsurance contracts. The Authority says that no real reinsurance risk was involved and that the transactions were entered into and used to disguise losses and/or misrepresent financial accounts.

2. The Authority issued a Decision Notice dated 14th December 2007 ("the 15 Decision Notice") signed by the Chairman of its Regulatory Decisions Committee ("RDC"). The Decision Notice informed the Applicant that the Authority had decided pursuant to Section 56 of the Financial Services and Markets Act 2000 ("the Act"): "*... to make an order prohibiting Milan Vukelic ("Mr Vukelic") from performing any function in relation to any regulated* 20 *activity carried on by any authorised or exempt person or exempt professional firm"*. On the 9th January 2008 the Applicant referred the matter to this Tribunal.

Role of the Tribunal

25 3. The party against whom the Authority makes a prohibition order has a right under Section 57(5) of the Act to refer the matter to the Tribunal which under Section 133 (4) must "*determine what, (if any), is the appropriate action of the Authority to take in relation to the matter referred to it"*. We are not hearing an appeal against the Decision of the Authority but reviewing from the start 30 the facts and matters which led to it. This case has therefore been a complete rehearing of the issues which gave rise to the decision.

The statutory and other regulatory provisions in more detail

4. The Authority's regulatory objectives are set out in Section 2(2) of the Act. These include:

35 (a) market confidence;

(b) the protection of consumers;

(c) the reduction of financial crime.

5. Section 56(1) of the Act provides that the Authority may make a prohibition order if it appears to the Authority that the individual is not a fit and proper 40 person to perform functions in relation to a regulated activity carried on by an authorised person.

6. The Authority has issued specific guidance on the use of its power under Section 56. Guidance as relevant in this case is set out in the Enforcement Manual component of the FSA Handbook ("ENF") and other relevant guidance is set out in the Fit and Proper test for Approved Persons ("FIT").

5 Enforcement Policy

7. The FSA's policy in relation to prohibition orders is set out in Chapter 8 of the Enforcement Manual. ENF 8.1.2 explains that the purpose of prohibition orders is to help the Authority to further its regulatory objectives.

8. ENF 8.4.2 concerns the scope of the Authority's power to make prohibition orders: they may be unlimited, or they may be limited to specific functions in relation to specific regulated activities. The scope of the order will depend upon, *inter alia,* the reasons why the individual is not fit and proper, and the severity of risk which he poses to consumers or the market generally.

9. ENF 8.4.3 states that the Authority recognises that its decision to make a prohibition order will have a substantial impact on the individuals concerned and that the Authority will also consider all relevant circumstances in making such a decision.

10. ENF 8.8.1 states that the Authority will consider exercising its power to make prohibition orders against individuals who are neither approved persons or employed by authorised persons where such individuals have shown themselves to be unfit to carry out functions in relation to regulated activities.

11. ENF 8.8.2 states that the Authority will consider the individual's fitness or propriety where, for example, he appears likely to pose a serious risk to consumers or confidence in the financial system in the future.

12. ENF 8.8.2A states that, where it is considering whether to exercise its powers to make a prohibition order against such an individual, the Authority will not have the option of considering the adequacy of other enforcement action. The guidance provides that the Authority will consider the severity of the risk posed by the individual and may prohibit him where it considers that this is necessary to achieve the Authority's regulatory objectives.

13. ENF 8.8.3 provides that when determining the fitness and propriety of an individual who is neither an approved person nor employed by an authorised person, the Authority will consider the criteria set out in ENF 8.5.2G(1), ENF 8.5.2G(3) and ENF 8.5.2G(5).

14. ENF 8.5.2G provides that when the Authority decides whether to exercise its power to make a prohibition order the factors it will consider include, but are not limited to:

    (1) whether the individual is fit and proper to perform functions in relation to regulated activities and the criteria for assessing the fitness and propriety of approved persons which include those contained in FIT 2.1 (honestly, integrity and reputation). Honesty, integrity and reputation includes an individual's openness and honesty in dealing with consumers, market participants and regulators and ability and

willingness to comply with requirements placed on him by or under the Act as well as with other legal and professional obligations and ethical standards.

(3) the relevance, materiality and length of time since the

occurrence of any matters indicating unfitness;

(5) the severity of the risk which the individual poses to consumers and to confidence in the financial systems;

(6) the previous disciplinary record and general compliance history of the individual including whether the FSA (or any previous regulator) has previously imposed a disciplinary sanction on the individual.

15. The matters referred to in FIT 2.1.3G when assessing a person's honesty, integrity and reputation include, but are not limited to the following on which the Authority relies particularly:

(5) whether the person contravened any of the requirements and standards of the regulatory system or the equivalent standards or requirements of other regulatory authorities (including a previous regulator), clearing houses and exchanges, professional bodies, or government bodies or agencies;

(13) whether, in the past, the person has been candid and truthful in all his dealings with any regulatory body and whether the person demonstrates a readiness and willingness to comply with the requirements and standards of the regulatory system and with other legal, regulatory and professional requirements and standards.

Questions of Law and Procedure

Dishonesty or nothing

16. The Authority's case is that Mr Vukelic acted dishonestly over each of the three transactions. Mr Vukelic's lawyers have contended that this is therefore a case of dishonesty or nothing. We put it to Mr Philipps QC for the Authority and Mr Flint QC for Mr Vukelic that, despite their respective positions, the Tribunal was free to make its own determination of whether or not Mr Vukelic was and is fit and proper taking account of the matters referred to in FIT 2.1.3.G. They accepted that and agreed that we were entitled to reach our own conclusions on grounds not necessarily involving dishonesty, provided of course that these were within the scope of the matters raised in the case and were fairly put to Mr Vukelic. Thus, for example, the Tribunal has power to conclude (as the Authority's Regulatory Decisions Committee ("RDC") did in this case) that Mr Vukelic was not dishonest but lacked integrity.

Proof of dishonesty or lack of integrity

17. It is for the Authority to prove its case to a civil standard. This standard is a flexible one and the more serious the allegation, or the more serious the consequences if it is proved, the stronger must be the evidence before the Tribunal will find it proved on the balance of probabilities.

18. Mr Flint QC submits that when considering dishonesty the test to be applied is that set out by the High Court in *Bryant –v-The Law Society* [2007] EWHC 3043 (Admin) following the Court of Appeal in *Bultitude -v- The Law Society* [2004] EWCA CIV 1853. The Tribunal needs to consider firstly whether the applicant acted dishonestly by the ordinary standards of reasonable and honest people and secondly whether the applicant was aware that by those standards he was acting dishonestly.

19. Mr Flint also relies on the fact that the Tribunal in *Hoodless & Blackwell v FSA* (3 October 2003) adopted the same approach as *Bryant* to the issue of dishonesty (at Paragraphs 18 and 19) and went on to deal with the question of integrity.

20. Before turning to integrity we refer to the fact that the Authority contended that the approach used in *Hoodless & Blackwell* to the question of dishonesty was misconceived and should be reconsidered. Mr Philipps QC submitted that in a case before the Tribunal honesty and integrity are used together describing different facets of 'fit and proper' and that it was a mistake to approach the issue in the way a court would when considering dishonesty as an essential ingredient of an offence. As we see it the distinction does not arise for decision in this case because there is no suggestion that Mr Vukelic was unable to appreciate what is honest and dishonest by ordinary standards. Furthermore the second limb, whether an applicant was aware that by the relevant standards he was acting dishonestly, will, we suspect, not often arise in a Financial Services case. Indeed an applicant relying on the second limb is generally going to find his fitness questioned on other grounds. We will not therefore review what was said in *Hoodless & Blackwell* about dishonesty.

21. On the question of integrity Mr Flint relies upon Paragraph 19 of *Hoodless & Blackwell* which reads as follows:

> *"It may be asked whether the combined test is really appropriate in the present context, where one of the statutory objectives is the protection of consumers. It might be thought that a purely objective test would be a better protection. But we think it right to adopt the approach urged upon us, since it was not in dispute that we were required, as an additional matter, to consider the applicants' integrity, which both sides accepted involved the application of objective ethical standards. In our view 'integrity' connotes moral soundness, rectitude and steady adherence to an ethical code. A person lacks integrity if unable to appreciate the distinction between what is honest or dishonest by ordinary standards. (This presupposes, of course, circumstances where ordinary standards are clear. Where there are genuinely grey areas, a finding of lack of integrity would not be appropriate.)"*

22. Mr Flint goes on to rely on the existence *"of genuinely grey areas*" in this case as compelling us to find that his client has not been dishonest or lacking in integrity.

23. We do not disagree with what is said about integrity in *Hoodless & Blackwell* but we do not take Paragraph 19 as being a comprehensive test which is of

application beyond the facts of that case. In an area of life giving rise to circumstances of great variety and complexity there may well be many other circumstances in which the FSA could fairly conclude that an applicant lacked integrity, a concept elusive to define in a vacuum but still readily recognisable by those with specialist knowledge and/or experience in a particular market.

Evidence, documents and transcripts

24. The Tribunal has a broad power to consider any evidence whether or not admissible in court proceedings and whether or not it was available at the time the Authority took its decision (Section 133(3)). That power is important to this case as appears from the manner in which it has been presented.

25. The Authority's case is based on what must be only a selection of the contemporaneous documents and on transcripts of telephone conversations, most of which were used in other investigations and disciplinary proceedings. The Authority also drew attention to other disciplinary proceedings arising from the transactions including that involving Mr Vukelic before the Australian Prudential Regulation Authority ("APRA"). The Authority called an expert Mr Hulse, a Partner in KPMG LLP, but no witness of fact. The applicant, Mr Vukelic, gave evidence and relied upon two expert witnesses: Mr Ryan, an actuary, and Mr Shanahan, formerly a Partner in the Sydney office of Deloitte Touche Tohmatsu and a Consultant Accountant. We consider the experts separately. The international nature of this case, the amount of time that has gone by since the transactions, the extent of the previous disciplinary proceedings and the requirement for cases to be conducted at proportionate length and cost made this approach inevitable and also fair provided the material was handled with appropriate caution.

26. Mr Flint urged the Tribunal to treat the transcripts of telephone conversations with considerable caution. He drew our attention to the following observations in Paragraph 23 of *Hoodless & Blackwell:*

> "*It is easy to be misled by such transcripts, language is often used very loosely on the telephone with ungrammatical instructions, full stops left uncorrected, figurative usages and incorrect choices of words. Not everything said is intended to be taken literally or to be taken seriously…… . Much depends on context, on tone, and on the nature of the relationship between the speakers*".

27. As Mr Flint points out these complex transactions developed over time and it is not always clear from the transcripts what aspect is under consideration. Not all comments are or are intended to be judgements and many remarks are ambiguous. We accept this need for caution and respectfully agree with what is said in *Hoodless & Blackwell* and also bear in mind that the transcripts are extracts from what will have been a very much larger number of conversations of which we have no record. We also accept that while it is tempting to rely upon conversations to which Mr Vukelic was not a party as giving a flavour of the culture of the business for which he was responsible, this would be unfair. It is dangerous to do this without access to a broader picture and when no

evidence is available about the circumstances in which particular individuals came to say what they did.

28. Against that the bundles contain a number of relatively full conversations which in our judgment frequently present a consistent approach. While exercising the caution urged upon us by Mr Flint we still judge it fair to place a degree of reliance on these transcripts.

Mr Vukelic's recollection

29. In Paragraph 7 of his witness statement Mr Vukelic points out that the transactions happened a long time ago and that his recollection of them is, on the whole, not good

> "*I have very little recollection of Zurich at all, for example. Prompted by the documents, I recall elements of all the deals but have limited recall of many facets and details. FAI and New Cap, I do remember slightly more*".

30. During the course of his evidence Mr Vukelic frequently referred to the fact that he lacked any recollection of particular matters. At the end of his evidence I asked Mr Vukelic whether our impression that he had even less recollection than he had mentioned in Paragraph 7 was broadly right. He agreed with that and said

> "*I recall very little about any of the transactions. I recall snippets of things and frankly my recollection even then is suspect*".

31. We recognise that a recollection of events 8 to 10 years ago may be limited. These were very important transactions however, as Mr Vukelic accepted, and he has had his attention drawn to them in some detail regularly since at least the APRA investigations in 2004. Everyday experience leads us to be a little surprised that Mr Vukelic's recollection is so limited but the matter was not challenged by the Authority and we therefore accept that he was doing his best to recall all relevant matters. Both sides therefore face the difficulty that Mr Vukelic's evidence is little more than a reconstruction based on the documents and other circumstances of his best judgement of what he knew at the time. Mr Flint suggests that Mr Vukelic's evidence is useful to this extent; it is his best recollection of how he saw the transactions at the time and to the extent that the problem of memory results from the passage of time, fairness demands that the evidence be taken into account. We are nevertheless left in the position that Mr Vukelic has no reliable recollection of what he knew when. His reconstruction is also less likely to be accurate than the one we have been able to carry out with the assistance of the lawyers on both sides. But we have to bear in mind that any inconsistencies in answers may have occurred because of reconstruction difficulties rather than lack of truth. It is for this reason that we refer in this Decision to very little of Mr Vukelic's evidence and cross examination.

Other Investigations and Enquiries into the three Transactions

32. The FAI Transaction was the subject of detailed analysis by the Royal Commission on HIH and gave rise to criminal proceedings. The New Cap

Transactions led to substantial litigation by investors who claim to have been misled by accounts in the capital raising prospectus. The Zurich Transaction led to extensive regulatory investigation in Australia. In October 2004 Mr Houldsworth, the Chief Underwriter of AltSol, was disqualified by APRA from being, or acting as, a Director or Senior Manager of a General Insurer in Australia because of his involvement in FAI. Mr Ellingsen, the Sales Person who initiated the FAI and Zurich Transactions, was also disqualified as were four individuals of GCRA who in addition served 12 months disqualification by the Australian Securities and Investments Commission. In July 2006 Mr Houldsworth's deputy, Mr John Byrne, agreed to prohibition for 5 years by both the Authority and by APRA in connection with his involvement in four transactions including FAI and Zurich. In June 2005 Mr Houldsworth pleaded guilty to federal criminal conspiracy charges in Boston. On 16 July 2007 Mr Vukelic was disqualified by APRA from being or acting as the holder of a senior insurance role in Australia on the ground of his involvement in the same three transactions as are the subject of the present proceedings. Mr Vukelic has appealed that decision and it has been stayed until the outcome of this application.

Financial Reinsurance

33. What is financial reinsurance, the specialist area which this case is about? The nature of financial reinsurance is summarised accurately by the Authority in its Statement of Case in the following terms:

2.1 "This case is based on three financial reinsurance transactions. Insurance transfers the risk of a potential loss from the insured to the insurer in exchange for a premium. Reinsurance is the insurance of an insurer. It is the means by which one insurance company can protect itself against the risk of losses on insurance policies it has underwritten by transferring the risk to a reinsurer.

2.2.1 Reinsurance is concerned with the transfer and assumption of risk. To be treated as reinsurance for regulatory and accounting purposes, there must be:

(1) underwriting risk (that is, uncertainty as to whether or not the loss event will occur and/or the ultimate amount of any payments in respect of the loss event); and/or

(2) timing risk (that is, uncertainty as to when claim payments will be made)(together referred to as "insurance risk")

2.3 Financial reinsurance is a specialist type of reinsurance. The essence of financial reinsurance is that the insurance risk transferred to the reinsurer is limited. Whilst insurance and reinsurance are concerned with the pooling of premiums to pay claims, financial reinsurance is concerned with financing the payment of losses over a period of time.

2.4 Financial reinsurance can be a legitimate type of reinsurance where it involves the genuine transfer of insurance risk. However, if not properly accounted for, financial reinsurance can be misused to

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misrepresent the financial results and accounts of an insurance company. Transactions can be structured in such a way that they appear, on their face, to be genuine financial reinsurance transactions, but in reality they have no economic substance or purpose. Transactions may be structured so as to comprise multiple elements, some of which may be, on their face and individually, legitimate reinsurance contracts. However, for a true view of the position, all the elements must be considered together."

34 The manner in which reinsurance is accounted for in the financial statements of the insurance company which enters into it (or 'cedes' it to the reinsurer) is important to this case. If a transaction is one of reinsurance it is accounted for on the basis that the recoveries to which the ceding Insurance Company is entitled in the accounting period are shown as income in the profit and loss account and as an asset in the balance sheet, while the premium payable by the insurance company is an expense in the profit and loss account and a liability in the balance sheet. The transaction will not be accounted for as one of reinsurance, under most accounting regimes, unless it effects a significant transfer of risk. This means that there must be a significant uncertainty as to whether and/or when the reinsurer may have to make claims payments to the ceding Insurance Company. If the transaction does not transfer risk it will be accounted for as a deposit. The transaction will then have no overall effect on either the profit and loss account or the balance sheet. Behind this dry and technical requirement lies the potential for very serious abuse and the risk that a company's accounts may as a result give a falsely optimistic picture of its financial position.

Facts agreed or not greatly in dispute

35. In the 1990's financial reinsurance, devised primarily with a view to its effect on the accounts of the cedent insurer, grew into a large business, the participants in which included General Reinsurance Corporation ("Gen Re"). APRA referred in one of the disciplinary decisions which we mention to the perspective of Gen Re in October 1997 in the following terms, which give some insight into attitudes at the time;

"An internal report into the market and operations of the Financial Reinsurance Department dated the 20th October 1997 noted that the financial reinsurance products involving very little or no underwriting risk were becoming difficult to sell as they were being rejected or viewed unfavourably by insurance supervision authorities and changes to statutory accounting procedures made it difficult to access the benefits of financial reinsurance."

36. The internal report noted that Cologne Re (by then part of Gen Re) "*was altering its approach to selling financial reinsurance by using "blended covers" which contained an "acceptable" level of underwriting risk and by targeting clients that were not subject to the new statutory accounting rules, such as, for instance, state owned insurance companies in the United States that were not subject to the new FAS 113 accounting standard for reinsurance."*

37. This internal report also discussed the concept of "reinsurance engineering" referring to products that were on the borderline between reinsurance and banking and noted that the financial reinsurance department was monitoring developments in this area closely. A month before, Gen Re had established a multi-jurisdictional business unit known as Alternative Solutions ("AltSol") in a context to which we now turn.

38. General Re Corporation ("Gen Re") and its group companies (collectively the "Gen Re Group") operate an international reinsurance and financial services business. The Gen Re Group entities relevant to this matter are:

(1) General and Cologne Reinsurance Australia Limited ("GCRA");

(2) Kölnische Rückversicherungs AG – Australian Branch ("CRAUS");

(3) Cologne Re Dublin ("CRD"); and

(4) Külnische Rückversicherungs-Gessellschaft AG ("Cologne Re"). General Reinsurance Corporation ("GRC") acquired a controlling interest in Cologne Re during 1994 and the two companies began operating under the business name, General and Cologne Reinsurance.

(5) The Australian subsidiary of GRC, General Reinsurance Australia Ltd, was formerly known as General and Cologne Reinsurance Australasia Ltd and subsequently as General Cologne Re Australia Ltd ("GCRA"). Cologne Re also maintained a branch operation in Australia known as Cologne Re Australia ("CRAUS"). Unless otherwise specified, the subsidiary, GCRA, and the branch, CRAUS, are referred to as "GRA".

39. General Reinsurance Corporation acquired a controlling interest in Cologne Re during 1994 and the two companies began operating under the business name, General and Cologne Reinsurance. Mr Vukelic is a solicitor by training and a banker by experience. He joined Cologne Re in August 1997 as head of the Finite Business Unit of Cologne Re. He had not worked for an insurance company before but, as he mentioned in evidence in around 1988, he had moved to Chase Manhattan Bank where he had exposure to insurance companies, latterly becoming a managing director in the Chase Global Insurance Group. In August 1997 the Gen Re Group established a multi-jurisdictional business unit known as Alternative Solutions ("AltSol") with staff from several of the Gen Re Group entities, including Mr Vukelic as Chief Executive Officer ("CEO") and Business Unit Manager. His role was also known internally as the "business unit leader" or "business unit manager". He occupied the position of Chief Executive Officer from August 1997 until October 2002.

40. AltSol was a virtual business unit that was set up to develop and market financial reinsurance products. AltSol operated primarily from Cologne Reinsurance Company (Dublin) Ltd ("CRD"), but also had offices in London and Cologne.

41. AltSol was established to build on the work of the Financial Reinsurance Department of Cologne Re to develop and market the financial reinsurance capabilities of the Gen Re Group to a wider audience. As CEO of AltSol, Mr

Vukelic had responsibility for developing the Gen Re Group's financial reinsurance business outside the United States. As head of AltSol he had a significant oversight role and was responsible and accountable for all AltSol business. In addition, he had a right of veto over whether transactions went ahead.

42. Since AltSol was not a legal entity, business generated by AltSol had to be assumed by an entity in the Gen Re Group. Likewise, whilst fees for the transactions were not booked in AltSol, they were assessed in determining the contribution of the AltSol business unit to the results of the Gen Re Group.

43. Mr Vukelic left AltSol (where he was never an Approved Person) to become CEO of Faraday Reinsurance Co Limited ("Faraday Reinsurance"), another Gen Re Group company. Mr Vukelic was an Approved Person at General Reinsurance Life UK Limited between 12 September 2002 and 21 December 2004, in respect of controlled function ("CF") 1 (Director). Between 1 November 2002 and 5 July 2005, Mr Vukelic was an Approved Person at Faraday Reinsurance in respect of controlled functions CF1 (Director), CF3 (Chief Executive), CF8 (Apportionment and Oversight) and CF14 (Risk Assessment). Between 17 February 2003 and 5 July 2005, Mr Vukelic was an Approved Person at Faraday Underwriting Limited in respect of CF1 (Director), CF3 (Chief Executive) and CF8 (Apportionment and Oversight).

44. Mr Vukelic described his role at AltSol as follows:

"When I joined AltSol it was a fairly small team, with members based in different locations: London, Cologne, Dublin and Stamford. I was based in London and John Houldsworth, the AltSol Chief Underwriter, was based in Dublin. As he was the Chief Underwriter, I would meet with Mr Houldsworth on a monthly basis and talk to him regularly on the telephone.

As one of my particular strengths was business development, I was recruited to expand the business and client base of AltSol, particularly in respect of life reinsurance (none of the three transactions was a life reinsurance transaction). I assumed the title of CEO, although this was purely for marketing gravitas; I did not hold a board position within any Gen Re entity (later on I was appointed as a non-executive director on the board of Gen Re's UK Life Reinsurance subsidiary). My primary day-to-day responsibilities included team management; management reporting; recruitment; and business development strategy. I was explicitly not authorised to underwrite any transactions as that was the responsibility of the AltSol Chief Underwriter. In addition, to my management responsibilities, I also undertook business development and deal origination activities for my own deals. This included securing new work opportunities from entities that had been clients or targets of mine while I was at Chase Manhattan. Examples included: Windsor Life/LAHC; Friends Provident; NPI; Top Glory/Pacific Century Insurance and CGNU (now Aviva)".

Mr Vukelic did not suggest that he lacked support or advice from superiors when he sought this. A chart of the management structure is set out in Schedule 4 of Mr Vukelic's Opening Submissions.

Summary of the position of the parties about the transactions.

45. This case concerns three transactions in which AltSol participated between 1998 and 2001, which we describe in more detail below as the FAI Transaction, the New Cap Transaction and the Zurich Transaction.

46. The Authority says that these were presented as insurance risk transferring reinsurance but were in substance non insurance risk transferring and were used by AltSol's clients to disguise losses or misrepresent financial accounts.

47. The Authority summarises its case at paragraphs 4.2 to 4.7 of its Statement of Case.

> *4.2 "The Transactions allowed the Gen Re Group's counterparties the ability to misrepresent their true financial position to regulators, auditors, tax authorities, the insurance market and, where the counterparty was a listed company, listing authorities and investors.*
>
> *4.3 Mr Vukelic was responsible for overseeing and structuring the Transactions and was aware of their material aspects. As head of AltSol, Mr Vukelic had overall responsibility for transactions that AltSol entered into. He had an express power of veto. He did not exercise this power in relation to any of the Transactions nor did he raise any concerns with more senior management.*
>
> *4.4 In respect of each of the Transactions, Mr Vukelic knew:*
>
> *(1) the counterparties to the Transactions were in financial difficulty and the sole purpose of the Transactions was to provide the counterparties with a substantial accounting benefit by the Transactions being treated in their accounts as reinsurance transactions;*
>
> *(2) the Transactions were in fact not genuine reinsurance transactions because they were specifically structured to avoid the transfer of any insurance risk; and*
>
> *(3) if the auditors of the counterparties knew that the Transactions did not achieve insurance risk transfer they would not agree to the Transactions being shown as reinsurance transactions in the relevant counterparty's accounts and the objective of the Transactions would not be achieved.*
>
> *4.5 It follows from Mr Vukelic's knowledge of these factors that he must have also known that the counterparties' auditors would have to be misled as to the true nature of the transactions in order for the Transactions to achieve their purpose. Indeed, the Transactions were deliberately structured in a complex way using a number of contracts, which appeared on their face to be unrelated, and this facilitated the concealment of the true nature of the Transactions from the auditors.*
>
> *4.6 In relation to each of the Transactions, one or more of the constituent elements was withheld from auditors and/or regulators who were not*

therefore able to appreciate the overall economic effect of the transactions.

4.7 Each counterparty paid the relevant Gen Re Group entity a substantial fee for undertaking the Transaction. The sole economic benefit for the counterparty was the ability to misrepresent its true financial standing."

48. Mr Vukelic's response can be summarised as follows:

1. There was and is nothing inherently improper, whether from an accounting perspective or otherwise, in:

    a. the agreement by companies in the Gen Re Group entering into reinsurance contracts with the knowledge that another party to those contracts is entering into a contract for the purpose of obtaining an accounting or solvency advantage.

    b. a reinsurance transaction being structured so as to comprise separate contracts in which one contract provides compensation for liabilities (or potential liabilities) assumed under another contract.

2. The three Transactions were not affected by any impropriety on the part of companies in the Gen Re Group. Each involved the transfer of risk from the reinsured to the re-insurer. The fact that Mr Vukelic was involved in, and supported, those Transactions does not imply any culpability on his part.

3. It was the responsibility of the auditors of the re-insureds under each of the three Transactions to decide whether, from an accounting perspective, each transaction could be taken into the accounts of the particular reinsured. This was not Mr Vukelic's responsibility, nor that of AltSol.

4. It was the responsibility of the directors of each of the reinsureds under the three Transactions to disclose to that reinsured's auditors the structure of the transaction. This was not Mr Vukelic's responsibility, nor that of AltSol.

5. Mr Vukelic did not know of, nor suspect, nor deliberately assist in, any failure by the directors of the client reinsureds properly to disclose the transactions to their auditors. Mr Vukelic did not set out to, and did not knowingly, mislead those auditors. Mr Vukelic did not behave dishonestly or with a lack of integrity in relation to any of the three Transactions.

6. In all circumstances, the FSA should not have concluded that Mr Vukelic (1) is not a fit and proper person to perform any function in relation to a regulated activity, or (2) poses a risk to the FSA's statutory objectives. Accordingly, a prohibition order against Mr Vukelic is an inappropriate and a disproportionate punishment.

The Expert Evidence – General

49. The Tribunal heard evidence from three experts, as we have mentioned at paragraph 25 above, Mr Hulse, Mr Ryan and Mr Shanahan. All three witnesses did their best to assist the Tribunal and we are grateful to them. We refer to their evidence in more detail when dealing with the three transactions but first make some general points.

50. Mr Hulse was a notably impressive witness with a formidable grasp of the facts and the issues. He had the advantage of having been involved in examining the three transactions and similar ones for a considerable time but it was not suggested, and could not reasonably have been suggested, that his professional judgment had been coloured by his involvement. Mr Flint suggested that Mr Hulse's testimony was undermined by three matters. First his approach to the question of 'payback' was said to be inconsistent but we did not consider that any of the three transactions, looked at in context, could be seen as legitimate 'payback' deals as we shall explain. Secondly we did not consider that uncertainty about the concept of 'constructive obligation ', if there was any, undermined Mr Hulse's evidence. Thirdly we reject the criticism that Mr Hulse retreated to looking at substance rather than form when considering Australian standards about which he was less qualified to express a view than Mr Shanahan. That is precisely what we would expect an experienced professional of integrity to do when faced with transactions such as these.

51. Mr Ryan was not an experienced expert witness and lacked the detailed knowledge of the other experts. Although an actuary, his testimony was directed mainly at accounting and insurance matters. He fairly accepted that some of his reasons for considering the transactions to be legitimate fell away when both legs were looked at together and in context.

52. Mr Shanahan had a better knowledge of Australian accounting standards than his colleagues but, again, his reasons for accepting the legitimacy of the transactions were unconvincing when matters were looked at overall and in context. We are particularly grateful to Mr Shanahan for giving evidence by videolink late at night in Australia and in the face of health challenges.

53. The role of expert evidence in this case is however limited as both sides accepted to a degree and we therefore do not examine it in much detail. As the Authority sees the matter, detailed analysis of the contracts is pointless because no one doubts that viewed in isolation each leg of each transaction transferred risk. Further, as Mr Vukelic was not familiar with the detailed terms, expert evidence about whether a transaction transferred sufficient risk for an auditor to adopt insurance rather than deposit accounting standards is beside the point. The Authority says that this case is about decisions to approve transactions which would and did involve the auditors being kept in the dark. If the case is proved, the fact that a transaction might later be argued to be justifiable for reasons of which Mr Vukelic knew nothing at the time is irrelevant. For Mr Vukelic it was submitted that the expert evidence was mainly background. It supports the point that there was a tenable view that

these transactions were properly capable of being accounted for as reinsurance - although Mr Flint accepted that this did not apply to FAI in the light of the side letters. For our part we found the expert evidence very helpful as background and as guiding us to the significance of some of the reinsurance issues but of limited relevance to the central questions we have to decide.

The FAI Transaction - the essence

54. FAI Insurances Ltd ("FAI") was a well established and well known Australian general insurance company offering a wide range of cover to homes and businesses. By 1998, as Mr Vukelic knew, FAI had a significant shortfall in its loss reserves which it wanted to reduce. The purpose of the FAI Transaction was to strengthen the company's reserves. As a result of the FAI Transaction the company was able to state assets in its accounts as being A$35.657 million. AltSol, or rather the relevant Gen Re entity, was paid of fee of A$4.75 million.

55. In May and June 1998, FAI entered into "aggregate excess of loss" contracts known as "AXOL 1" and "AXOL 2", by which GCRA reinsured the company's professional indemnity business. The parties had a parallel arrangement whereby GCRA reinsured FAI under 6 separate reinsurances ("the Six Slips") for a premium. By side letters FAI agreed not to claim under the Six Slips unless mutually agreed otherwise by the parties. FAI's auditors were not told of the Six Slips or the side letters and thus had no reason to question AXOL 1 and AXOL 2 because, although aware of the first leg of the transaction, they were unaware of the second.

56. In 1999 FAI was acquired by another Australian insurer HIH Insurance Group ("HIH"). HIH went into liquidation in 2001 with a very large deficiency. Such was the disquiet that the Australian authorities set up a Royal Commission to consider the circumstances surrounding the failure of HIH to which it seems the FAI Transaction was a significant contributing cause.

The FAI Transaction – In Detail

57. There were two legs to the FAI Transaction. The summary which follows is taken from the Authority's Statement of Case but has not been significantly challenged.

58. The elements of Leg 1 were as follows:

"(1) AXOL 1 between FAI (as reinsured) and GCRA (as reinsurer) provided A$65 million of cover for a premium of A$55 million, resulting in an apparent insurance risk for GCRA of A$10 million. AXOL 1 was a continuous contract incepting on 1 January 1998. The contract recorded on its face that it was signed and dated 16 March 1998 by both GCRA and FAI. However, it appears that it was actually signed on or around 6 May 1998 and backdated;

(2) payment of the premium of A$55 million for AXOL 1 did not have to be made by FAI until 1 January 2003. AXOL 1 included a premium deposit clause which stated that FAI would hold, on behalf of GCRA, 100 per cent of all premium payments until this time. Likewise, GCRA

was required to make any claim payments to FAI until 1 January 2003. The Authority says that the effect of this was that FAI was able to recognise accounting benefits from the reinsurance transaction in its balance sheet, without having to fund any premium payments;

5 (3) *in relation to the intention to defer any monies due under AXOL 1, the AXOL 1 contract contained an offset clause:*

> *"Either party may at its discretion set off against any amounts due from the other party hereunder or under any other agreements between the parties hereto any amounts which are*
10 *due under this or those other agreements "*

(4) *FAI (as reinsured) and GCRA (as reinsurer) entered into the Six Slips, each of which covered different classes of insurance business and which appeared to be traditional reinsurance. Each of the Six Slips was signed by GCRA and dated 1 May 1998. Four of the Six Slips*
15 *incepted on 1 May 1998 for a total period of 24 months. For the remaining two, the inception dates were:*

> (a) *30 April 1998 for 24 months; and*
>
> (b) *all business allocated by FAI to its 1996/97, and 1998/98 financial years of account commencing 1 July*
20 *1996.*

(5) *the total premium for the Six Slips was A$12.5 million. It is not possible to quantify the total amount of cover under the Six Slips as the limit of cover of two of them is expressed as a percentage of FAI's loss ratio. However, on their face and in isolation, the Six Slips appeared*
25 *to transfer insurance risk to GCRA from FAI;*

(6) *FAI was required to pay the premium of A$12.5 million under the Six Slips in two equal instalments on 1 May 1998 and 1 July 1998;*

(7) *the premium of A$12.5 million under the Six Slips was to:*

> (a) *pay back GCRA for the A$10 million insurance risk*
30 *under AXOL 1, thus eliminating the insurance risk transfer of A$10 million arising under AXOL 1; and*
>
> (b) *pay AltSol and GCRA their fee of A$2.5 million for entering into the arrangement.*

(8) *a side letter was issued by FAI to GCRA, dated 1 May 1998 ("the First*
35 *Side Letter"), stating that "despite the contractual intention of the [Six Slips], unless mutually agreed by both parties, FAI will not seek reinsurance recoveries". The effect of this was to eliminate the insurance risk transfer arising under the Six Slips; and*

(9) *a side letter was issued by GCRA to FAI, dated 6 May 1998 ("the*
40 *Second Side Letter"), which linked AXOL 1 with the Six Slips. It stated that, in the event the performance of AXOL 1 "be prohibited or*

rendered inoperable", GCRA would return the premium of A$12.5 million under the Six Slips to FAI.

The Authority claims that the effect of Leg 1 of the FAI Transaction was as follows:

(1) AXOL 1 on its face and in isolation carried an insurance risk of A$10 million;

(2) the Six Slips on their face and in isolation carried an insurance risk;

(3) the Second Side Letter confirmed the link between AXOL 1 and the Six Slips;

(4) the effect of the Six Slips was to eliminate the insurance risk under AXOL 1; and

(5) the effect of the First Side Letter was to eliminate the insurance risk under the Six Slips.

59. The Authority says that when viewed in its entirety there was no insurance risk transfer in Leg 1 of the FAI Transaction. GCRA/AltSol received a fee of A$2.5 million for which they assumed no insurance risk.

60. Leg 2 of the FAI Transaction was as follows:

(1) *The terms of AXOL 1 were subsequently re-negotiated by FAI and AltSol/GCRA in June 1998. This resulted in AXOL 2, which replaced AXOL 1. The reason for this was that FAI wanted to increase the amount of cover under AXOL 1. Like AXOL 1, the period of AXOL 2 was continuous, incepting 1 January 1998. AXOL 2 was signed by GCRA and FAI and dated 26 June 1998.*

(2) The Six Slips and the First and Second Side Letters remained unchanged.

(3) A side letter was issued by GCRA to FAI dated 26 June 1998 ("the Third Side Letter"), stating that AXOl 1 was replaced by AXOl 2 to "ensure that the contract terms are clearly expressed".

(4) Under AXOL 2 the amount of cover for sections 1 to 3 remained the same as AXOL 1, that is, A$65 million. However, another three sections were added to AXOL 2 to increase the amount of cover apparently extended to FAI. The amount of purported cover for section 4 was A$11 million, for section 5 was A$11 million and for section 6 was A$18 million (but the aggregate amount of cover for sections 4 to 6 was limited to A$22 million).

(5) The total amount of cover under AXOL 2 was therefore A$87 million, whilst the total premium was A$77.25 million. The purported insurance risk gap to GCRA therefore decreased to A$9.75 million under AXOL 2 compared to AXOL 1.

(6) The premium under AXOL 2 was split into A$75 million for sections 1 to 5 and A$2.25 million for section 6. Like AXOL 1, the payment of premium

under AXOL 2 was deferred until 1 January 2003. However, this clause only applied to sections 1 to 5 of the contract. The premium for section 6 was split into five equal instalments of A$450,000, a total of A$2.25 million, payable at six-monthly intervals from 30 June 1998. AXOL 2 included an offset clause, which mirrored the offset clause in AXOL 1.

(7) Another side letter was issued by FAI to GCRA dated 26 June 1998 ("the Fourth Side Letter") in relation to section 6 of AXOL 2, which stated:

(8) "Despite the contractual intention of Section 6 in this Aggregate Excess of Loss Reinsurance Contract, unless mutually agreed by both parties, FAI Insurance Group will not seek reinsurance recoveries under this section of the reinsurance contract".

(9) Additionally, the cover under section 6 of AXOL 2 was set at such a level that it was outside the scope of FAI's underwriting limits and as such, would never be triggered and did not constitute a transfer of insurance risk. In any event, the effects of the Fourth Side Letter was to eliminate the transfer of insurance risk to GCRA arising under section 6 of AXOL 2. The premium of A$2.25 million payable under section 6 was therefore the fee charged by AltSol and GCRA for Stage 2 of the FAI Transaction.

61. This Authority contends that the effect of Leg 2 of the FAI Transaction was as follows:

(1) AXOL 2, on its face and in isolation, carried an insurance risk of A$9.75 million;

(2) the Six Slips, on their face and in isolation, carried an insurance risk;

(3) the Third Side Letter (read together with the Fourth Side Letter) confirmed the link between AXOL 2 and the Six Slips;

(4) the effects of the Six Slips was to eliminate the insurance risk under AXOL 2;

(5) the effect of the First Side Letter was to eliminate the insurance risk under the Six Slips; and

(6) the effect of the Fourth Side Letter was to eliminate any residual insurance risk under section 6 of AXOL 2.

When viewed in its entirety there was no insurance risk transfer in Stage 2 of the FAI Transaction. The overall economic effect of Stage 2 of the FAI Transaction was that GCRA and AltSol received an additional fee of A$2.25 million for which they assumed no insurance risk.

62. The Authority contends that the FAI Transaction was structured in such a way that:

(1) FAI was required to pay a significant premium in return for which it purported to transfer insurance risk;

(2) in fact no insurance risk was transferred; and

(3) notwithstanding this, FAI treated AXOL 2 as reinsurance for accounting purposes.

63. In effect FAI paid GCRA/AltSol a total fee of A$4.75 million in order to obtain the accounting benefit of treating AXOL 2 as reinsurance. There was no other economic benefit in the Transaction for FAI.

64. Mr Vukelic's position as regards the propriety of the FAI Transaction, as opposed to his role in it, is as follows:-

(a) AXOL 1 transferred risk from FAI to GCRA. There was a high degree of likelihood (but not a certainty) of claims of A$65 million under AXOL 1. If there was a total loss, GCRA would lose A$10 million. The Six Slips were also legally binding and transferred risk. The premiums payable to GCRA under the Six Slips were intended to compensate GCRA for the risk of loss under AXOL 1 with A$2.5 million payable as a fee. The effect of the premium for the slips was not to eliminate any risk under AXOL 1 but to compensate GCRA for that risk. The fact that the Six Slips were intended to compensate GCRA for risk assumed under another part of the Transaction did not make the Transaction improper or risk free.

(b) The Side Letters do not create legally binding commitments (a point that, correctly in our view, was not developed at the hearing).

(c) AXOL 2 was a legally binding reinsurance contract, transferring risk from FAI to GCRA. Section 6 of AXOL 2 was not set at such a level that it would never be triggered and even if it had been it would not have eliminated the risk of loss under AXOL 2 as a whole.

(d) Mr Vukelic's position as regards his role in the FAI Transaction starts from the fact that he was not a specialist and looked to underwriters and accountants on his team for detailed advice and assistance. He had no involvement in drafting the Six Slips which were the work of GCRA not AltSol. Mr Vukelic would have had no objection to the transaction being contained in a single document as opposed to being supplemented by side letters (see Mr Vukelic's e-mail of 1 May 1998 *"…I guess we can live with a side letter (if that is still the plan provided it is signed by e.g. Rodney and Tim) but I would rather that exposure was limited in the wordings…."*). Mr Vukelic did not see the side letters. He believed they comprised a non binding statement of intention by FAI that it would subsequently make GCRA whole in the event of any claims against GCRA under the Six Slips. As he put it in evidence, Mr Vukelic says that he believed the side letters were the equivalent of a business "handshake". Mr Vukelic believed that the transaction, when viewed as a whole, involved the transfer of risk from FAI to GCRA and that this was a genuine and legally binding reinsurance transaction. As far as he was aware FAI's directors would and did make a full and proper disclosure to auditors of all relevant aspects of the Transaction and this was effected with the

full knowledge of all relevant senior officers and employees at Gen Re, GCRA and AltSol.

FAI – expert evidence

65. All three experts agreed that there needed to be a transfer of insurance risk in order for a transaction to be treated as insurance in the audited accounts and that financial insurance products should be "deposit accounted". Mr Hulse accepted that Australian accounting standards had been slow to evolve but stated that where there was a deficiency of standards, auditors would revert to primarily US or sometimes UK standards. The fundamental principle, that the accounting "*treatment should fairly state or provide a true and fair view of the company's affairs and its results for the period ....both informs and takes precedence over individual accounting standards where conflict arises*." Mr Shanahan drew the Tribunal's attention to (the former) AASB 1023: Financial Reporting of General Insurance Activities which was in force at the time but, unlike the US standard FAS 113, did not define insurance risk. Mr Shanahan accepted the hierarchy of relevant accounting policies which was outlined in the HIH Royal Commission – Report on Reinsurance Contracts by G Couttas dated 6 February 2002: AASB 1023 was not appropriate where transactions were financial and not insurance; it is necessary to reflect the substance and not the form of the transaction, the economic effect of the transaction and for the financial statements to give a true and fair view. He also accepted the importance of FAS 113 (para 8) "*determining whether a contract with a reinsurer provides against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related insurers*" and Mr Couttas's statement that a contract would not meet the conditions for reinsurance accounting if features of the reinsurance contract or other contracts directly or indirectly compensate the reinsurer or related reinsurers for losses.

66. Mr Ryan and Mr Shanahan both accepted that, while they believed AXOL 1 and 2 and the Six Slips contained risk, there would not be any risk transfer if the Side Letters were legally binding. Mr Shanahan, in his witness statement, went on to say that in his opinion "*a literal interpretation*" of the First Side letter would only have effect on the first and fourth of the Six Slips (in which case sufficient risk remained in the transaction to justify insurance accounting), but this was not pursued by Mr Phillips in cross examination. Mr Flint accepted in his closing submissions that the appropriate accounting treatment of the FAI transaction "turned on" the Side Letters.

67. The Tribunal was not asked to consider the legal effect of the Side Letters. Although some expert opinion touched on this, the issue was not developed by Counsel in argument. The Side Letters were plainly intended to be relied upon. All three experts agreed that the assessment of risk transfer is a matter of judgment for the auditors and that they would expect the cedant company to disclose all relevant information to them. This should have included disclosure of the Side Letters. The Tribunal had the benefit of seeing both Ms Pearson's

and Mr Couttas's reports to the HIH Royal Commission. Ms Pearson concluded that, if the Side Letters were considered to be legally binding, there was no possibility that GCRA would make a loss. Mr Couttas used Ms Pearson's figures and opined that to deposit account was the correct way to account for this transaction. If the auditors had done so, this would have reduced FAI's pre-tax profit by A$35.7million in year ended 30 June 1998, increased the profit by A$6.6million in 1999 and reduced it by A$12.5million in 2000. FAI's net assets at 31 December 1998 would have been reduced by A$32.9million.

68. We accept the general contention of the three experts that individual auditors may take a different view when they determine whether a transaction should be treated as reinsurance or a financial transaction, but in the case of FAI (as in the other two transactions) the auditors were deprived of the opportunity to consider all the relevant information.

FAI - was there a transfer of risk?

69. By the end of the hearing Mr Vukelic accepted that the effect of the side letters, whether or not they were strictly binding in law, was to eliminate any insurance risk that might otherwise remain under the Six Slips and under section 6 of AXOL 2. The HIH Royal Commission concluded that the FAI Transaction involved the payment of more premiums and fees than total recoveries, with no legitimate commercial benefit being conferred on FAI thereunder. As is clear from the conclusions we reach about the expert evidence, we do not consider it seriously arguable that the FAI was a genuine reinsurance transaction. The side letters make it clear that it was not. If the auditors had seen the side letters and been made properly aware of the second leg, FAI's accounts would never have been improperly inflated as they were. The question with FAI is not whether it was a proper transaction but the nature and extent of Mr Vukelic's involvement with it.

FAI – the role of Mr Vukelic

70. The Authority alleges that Mr Vukelic knew that this scheme would only work if the second leg was concealed from the auditors, as it was. The FSA relies on Mr Vukelic's admitted knowledge of the link between AXOL and the Six Slips and of the contemplated use of a side letter to eliminate risk transfer under the slips. Mr Vukelic was closely involved in discussions about the structure and in talking to FAI and understood that, taken as a whole, there was no insurance risk transfer. The Authority says that Mr Vukelic knew and understood that this was not a genuine reinsurance transaction, that the transaction structure was designed to facilitate the concealment from the auditors.

71. The Authority relies upon contemporaneous records in the form of e-mails and telephone transcripts. It suggests that an e-mail of 20 March 1998 shows that there was a degree of secrecy because only a few specified people would know of the transaction. The Authority focuses on the 1 May 1998 e-mail we have already referred to in which Mr Vukelic asks to be kept informed (with a

reminder on 8 May). In addition to observing that he can live with the side letter provided it is signed by two senior people *"I would rather that exposure was limited in the wordings (e.g. restricted claims made timeframe)* Mr Vukelic asks whether *the risk layers we are taking (both the A$12.5 mm and any others)- are they at preferential rates or right on the market?"*. The Authority points to this message as a recognition, regardless of its legal force, that the side letter was intended to affect the overall structure, hence the requirement for it to be signed by senior people at FAI. The Authority responds to Mr Vukelic's expressed willingness to record the transaction in the contract rather than the side letter by submitting that the practical limitations on exposure would not be known by the auditors. Mr Byrne, an underwriter at AltSol and an Accountant, wrote in an e-mail of 25 June 1998, copied to Mr Vukelic, *"clearly we do not expect to pay this layer but they (FAI) need to persuade their auditors that (we) will pay it"*. When discussing section 6 of AXOL 2 on the following day in a conversation with Mr Houldsworth (but unknown to Mr Vukelic) Mr Byrne observed *"they [FAI] are going to try to con the auditors"*. We emphasise that Mr Vukelic was not party to the latter conversation. On 25 March Mr Ellingsen had sent a draft of AXOL 1 that he had prepared at AltSol to underwriters at GCRA with a covering e-mail copied to Mr Vukelic explaining that he and Mr Houldsworth would explain on the telephone *"how we envisage this structure working. We are sure this will not be apparent at first glance"*. There are other indications, which at least on one reading, would indicate that Mr Vukelic was aware that clause 6 could never be called on. For example he says in a transcript dated 25 June *"....we can cover with a supercat that can never be triggered anyway and even if it were triggered we would have a side letter saying they wouldn't call it"*. In a subsequent conversation they asked the question *"and are you happy that this thing can never be hit?"* – a reference to the catastrophe cover in clause 6.

72. As we have already pointed out there are dangers in placing much reliance on the e-mails and transcripts. But there are also difficulties in accepting Mr Vukelic's claims in evidence that there are innocent explanations when he has no independent recollection of these events. Despite what are in effect his submissions in evidence about the meaning of the e-mails, in most respects the less favourable interpretation urged by the Authority seems more plausible given the background, the form the transactions took and what others involved accepted the position to be. Further these records appeared to contradict Mr Vukelic's reconstructed recollection, particularly in regard to the side letters. For example he says in his witness statement *"had it occurred to me that the first side letter was legally binding or wanted to rely on it as a binding document (SIC) I would have, at the very least sought to review a copy of it and perhaps sought legal advice…"* The records do not support a recollection of the side letters being an informal and non binding commitment. Moreover it is inexplicable to us, given the size of the transaction and Mr Vukelic's position as CEO of AltSol, that he did not insist on seeing and giving the most careful scrutiny to the side letters.

73. While the Authority puts forward a powerful case for contending that Mr Vukelic must have known full well that the FAI transaction would not work unless the auditors were misled and that he acted dishonestly, we do not consider that, given the limitations on the quantity and quality of material available and the way in which justice requires us to approach the question, we can justly reach that conclusion. However we have no doubt that he was reckless.

74. AltSol was working at the boundaries of conventional reinsurance at a time when regulatory concerns about financial reinsurance were being expressed. Mr Vukelic knew this or plainly should have known it. AltSol itself described its mandate as *"alternative solutions business is broadly defined as:*

- *the provision of regulatory, quasi or contingent capital.*
- *the smoothing of existing or future volatility.*
- *enhancing tax, regulatory or balance sheet efficiency where the clients primary driver is not the transfer of traditional underwriting risk".*

75. This was a sophisticated product, careful supervision of which would be required to ensure that legitimate aims were properly achieved. Mr Vukelic was AltSol's Chief Executive Officer and was responsible for it even though Altsol was not a corporate entity. This was a large transaction for which a substantial fee was being paid. Mr Vukelic drew attention to the additional staff he brought into AltSol and the checks and balances he had installed. To the extent that Mr Vukelic lacked long and detailed experience of reinsurance and accounting matters, that was a particular reason for him to be wary and watchful of substantial business carrying potential regulatory risk. His approach as revealed by the documents (and indeed the absence of documents which we would have expected any manager to have insisted upon and which it is not suggested ever existed) seems to us to have shown reckless disregard of these risks and we are driven to conclude that he must have considered that if he had looked more closely at some of these matters details would emerge making it impossible for AltSol to proceed and to earn a significant fee for this transaction.

The New Cap Transaction

76. New Cap Reinsurance Corporation Ltd (Australia) ("New Cap") was a relatively new Australian insurer that had suffered substantial underwriting losses and *"wanted to avoid reporting a significant loss for the 1998 financial year".* New Cap approached AltSol in April 1998 seeking a solution that would "*smooth out it's projected P&L by taking a credit from a reinsurance in year 1 and repaying it over time".* As Mr Vukelic knew, New Cap prepared accounts under Australian GAAP for statutory and regulatory purposes and under US GAAP for submission to its bankers. Mr Vukelic attended a meeting with New Cap on 21st May 1998 and under "*purpose of meeting*" AltSol's note records "*key points to keep in mind we will not take underwriting or timing risks on this one given age of portfolio, nature of risks and of distress*

to client position". Some indication of the nature of the proposed transaction comes from the suggestion conveyed to Mr Vukelic in an e-mail of 27th June 1998 when considering a fee that "*a true test would be to make a market comparison such as the cost of a bank loan or New Capital issue*".

5 77. The Authority contends that the New Cap Transaction took the form of apparently unrelated reinsurance contracts each of which purported to transfer insurance risk. It contends that no insurance risk was transferred and that, given the need to look at transactions as a whole, Mr Vukelic knew and understood that this was not a genuine reinsurance transaction. Mr Vukelic 10 submits that, as he believed at the time, the transaction when viewed as a whole involved the transfer of risks from New Cap to GCRA and from GCRA to New Cap and that this was a genuine and legally binding reinsurance transaction.

New Cap – in Detail

15 78. It is again helpful to refer to these transactions as having two legs and to start with the Authority's summary. The elements of the New Cap transactions were as follows:

> *"(1) Leg One was a whole account excess of loss reinsurance contract between New Cap (as reinsured) and GCRA (as reinsurer) that* 20 *provided US$10 million of cover for a premium of US$3 million. Leg 1 had an inception date of 1 January 1998 (i.e. in New Cap's financial year ending 30 June 1998). On its face and in isolation Leg 1 exposed GCRA to an insurance risk of US$7 million;*
>
> *(2) Leg Two was a casualty excess of loss reinsurance contract between* 25 *GCRA (as reinsured) and New Cap (as reinsurer) that provided US$11 million of cover for a premium of US$300,000. The inception date of Leg 2 was 1 January 1999 (i.e. in the following financial accounting period, New Cap's financial year ending 30 June 1999). On its face and in isolation Leg 2 exposed New Cap to an insurance risk of* 30 *US$10.7 million;*
>
> *(3) payment of claims under Leg One was deferred until July 2000 and both Leg One and Leg Two included an offset clause, which enabled both GCRA and New Cap to take into account amounts owed to each other when calculating the amount of contractual premiums or claims* 35 *due."*

79. The Authority contends that the Legs were an exchange of known liabilities and the purpose of Leg Two was to eliminate the transfer of insurance risk in Leg One. No interrelationship between the Legs was disclosed in the contract although they were negotiated together and signed on 3 and 4 September 40 1998. The effect of the cash flow provisions under the Legs was to give GCRA a total net premium US$3.7 million before being required to pay any claims. In return New Cap received an accounting benefit. New Cap's auditors were not informed of Leg Two. As a result, the insurance risk transferred under Leg One was accounted for as a reinsurance contract,

allowing New Cap to overstate its profit. New Cap went into administration in April 1999 and liquidation in September.

80. The Authority submits that the starting point is Mr Vukelic's admissions that that there would be two legs to the transaction and no risk of loss for GCRA. He also admits in retrospect some doubts about the New Cap Transactions and those doubts first appear in his interview with the Authority but he does not repeat these in his witness statement. He observes (Paragraph 93) that "*there was nothing to suggest to me at the time that any aspect of the New Cap Transaction was improper*". He relies upon the involvement of all the relevant personnel of the various companies concerned as making him believe that the transaction was being undertaken transparently and appropriately. In his evidence to the Tribunal Mr Vukelic said this:-*"my view on this transaction has flipped and flopped over a number of years, but I maintain that, of the three Transactions, in retrospect this is the one that I personally am most uncomfortable with"*. He went on to indicate that AltSol had overstepped "*from the boundaries, if you…whatever your personal boundaries, if your boundary is there*". He also referred to the transaction as a somewhat naive and pretty blatant arbitrage of the accounting standards.

81. This recognition was somewhat at odds with the vigour with which Mr Vukelic sought to justify the transaction in his testimony and through the two experts who gave evidence on his behalf, Mr Ryan and Mr Shanahan.

82. Mr Vukelic accepts that he knew that New Cap was in financial difficulty and that the purpose of the transaction was to provide the company with an accounting benefit but he did not know how it or its auditors intended to account for the matter. He contends that New Cap's accounting of the transaction was not materially misleading relying on what he contends is a finding to that effect of the New South Wales Supreme Court in the case of *Ingot Capital Investments & Others v Macquarie Equity Capital Market & Others [2007] NSWSC 124.* That case was not relied on in argument at the hearing.

83. Mr Vukelic relies on the fact that the P&L benefit from the First Leg was offset by the decision of the company's directors to increase its prudential margin thus showing no material net benefit. He relies upon this as an indication that the purpose of the transaction was not to mislead auditors or produce misleading accounts. He contends that there was a high degree of likelihood (but not an absolute certainty) of claims under each Leg. Both Legs were part of the same reciprocal transaction and each transferred risk which was different in terms of the liabilities covered (one being a whole account the other being a casualty covering a more limited class of business), the level of potential loss (US$7 million as opposed to US$10.7 million) and the timing, with each contract containing different dates for initial payment of claims.

84. Mr Vukelic contends that there was nothing improper about these transactions and that he had no reason to doubt that the company would make (and by August 1998 had made) full and proper disclosure to its auditors of both

transactions. Again he relies upon the knowledge and participation of all of his colleagues at GCRA and AltSol.

85. The Authority contends that if the transaction was to achieve its desired objective New Cap's auditors would have to be misled about two things. First they would have to be misled about the nature and extent of the connection between the Two Legs so that New Cap could bring into account recoveries under Leg One in an earlier accounting period than its liability to pay claims under Leg Two. Secondly (a claim advanced only at the hearing) the auditors would have to be misled as to when claims were incurred when being persuaded to spread liability over a number of years.

86. The Authority relies on evidence that AltSol took steps to conceal the connection between the two Transactions. When explaining the proposed Transaction to New Cap, Mr Vukelic, in a telephone conversation, observed that they would *"probably throw in enough other stuff in there to…confuse the issue"* (1 June 1998). In the same conversation Mr Vukelic enquired into New Cap's "*relationship…with your auditors, how aggressive are they likely to be in terms of actually looking through any structures…..putting together enough components to some of these transactions that is very difficult for anyone to know what the hell is going on*". We were unconvinced by Mr Vukelic's suggestion that his remarks were flippant or casual observations. On 15 June Mr Houldsworth spoke to Mr Vukelic about placing other "*pieces*" in the cover "*just to sort of make it a bit more anonymous*" and expressed concern about a colleague, who had run into the deputy chairman of New Cap, saying too much about the transaction. An e-mail about a draft slip copied to Mr Vukelic on 25 June invites colleagues to "*open and change where you think this contract mirrors too closely the business accepted*". An e-mail of 2 July 1998, again copied to Mr Vukelic suggests, amongst other things, "*amend claims settlement clause so that it does not mirror the inward contract and, if required, provide New Cap with a side letter confirming that we will not put losses to them until 1/12/2003*".

87. There are other conversations in similar terms although Mr Vukelic was not party to the more explicit and so we do not hold those against him. All the conversations to which Mr Vukelic was a party seem broadly consistent with a wish by AltSol and New Cap to conceal the link between the Two Legs. Moreover on 20 August in a telephone conversation Mr Vukelic refers to the concern of one of the Australian directors of New Cap that "*if somebody were to buy the company or if somebody were to make a significant investment in the company they would lay themselves open to significant liability,if it was discovered after the fact that they had understated their net assets – or rather overstated their net assets*". In a telephone conversation with Mr Houldsworth on 3 September 1998 Mr Vukelic says "*why didn't we stick a loss in Australia*". Mr Houldsworth responds that the clients did not want to have the same two legs in the same place because "*if it's in the Australian office everybody in our office down there will know there's two deals with New Cap, one giving a profit and one giving a loss and they didn't want everybody to*

know that". Mr Vukelic suggested that the concern is about knowledge related to the insurance market not auditors.

88. Mr Vukelic relies upon an exchange in a telephone conversation of 21 August 1998 to show that at the time he believed the auditors had seen or would see both legs of the transaction and approve of Leg One being accounted for independently of Leg Two. At one point after referring to the Two Legs, Mr Houldsworth says "*yeah*" and Mr Vukelic responds "*....because they've been through the auditors*". Mr Vukelic submits "*they*" refers to the Two Legs but the Authority contends that the reference is to New Cap. A reading of the entire conversation and of these remarks in context suggests to us that Mr Vukelic was indeed referring to New Cap and not to the Two Legs. Against that Mr Flint QC for Mr Vukelic suggests that this is precisely the sort of ambiguity for which his client be given the benefit of any doubt. Mr Vukelic's interpretation seems inconsistent with a later remark where he refers to one New Cap director "*feeling uncomfortable about signing off on true and fair*".

Expert evidence - New Cap

89. Mr Ryan maintained that the two legs of the New Cap transaction, while reciprocal, did not cancel each other out, but that the two legs could still have significant risk transferred to GCRA when looked at as a whole. He said that, although there may have been sufficient information to suggest a total loss in 1998, it would have been difficult to predict with any certainty a total loss in 1999 and 2000 and that "*you are swapping two uncertain numbers*" in respect of liabilities. In cross examination Mr Ryan said that he did not consider Mr Vukelic's views that he would have expected the contracts to be total losses to be determinative as underwriters will often assume a total loss when considering pockets of business and pricing for structuring contracts. We find it difficult to accept Mr Ryan's evidence as he did not support his assertion that there was a net transfer of risk with any figures and in the light of Mr Vukelic's interview with the FSA in October 2005, which Mr Ryan may not have seen. In that interview Mr Vukelic states "*the intent ... there should be no risk of underwriting loss, net, net, net. ... yes there was risk in them but whether or not there was sufficient risk or the right risk for in aggregate it to be insurance in retrospect, I doubt*".

90. Mr Shanahan accepted that the economic effect of Leg 2 was to offset Leg 1 *"'In New Cap I believe that the leg 1 transferred insurance risk to GCRA, leg 2 was going to be a compensatory transfer in equivalent terms back.*" However, Mr Shanahan stated that both Legs could be accounted for as reinsurance under AASB 1023 and that under this accounting standard you only needed to show Leg 1 in the 1998 accounts, as Leg 1 incepted on 1 January 1998 and Leg 2 incepted on 1 January 1999. Under cross examination, he maintained that there are two separate accounting years in which you have to account for risk and premium and he did not accept that accounting for Leg 1 in 1998, without having regard for the impact on Leg 1 of Leg 2 in the subsequent year, would not show a true and fair view.

However, Mr Shanahan also said "*I am not aware of how you actually account for the two of them under AASB1023*".

91. Although Mr Hulse's report did not specifically refer to the two different inception dates of Leg 1 and Leg 2, it was clear under cross examination that he had been aware of this feature of the transaction and said "*in retrospect I should have referred to it ... the fact of the inception date of the contract should be set aside. You should have regard to the intention and the economic and commercial substance of the arrangement and the intention of the parties in order to make sure that the accounting is true and fair.*" Mr Hulse said that he disagreed with Mr Shanahan about the appropriateness of using AASB1023 and that the "*requirement to give a true and fair view overrides any individual accounting standard if there's thought to be a contradiction between the two.*" In his opinion, the existence of Leg 2 meant that no identifiable benefit was provided to New Cap by Leg 1 and that there was no risk transfer at the outset.

92. Unlike for the FAI and Zurich transactions, the Tribunal does not have the benefit of reports by the Australian regulatory authorities. We were taken to the auditor's memo to the Board Audit Committee of New Cap dated 27 August 1998. This stated that he had a different view as to the appropriate accounting treatment from the management and that he would pursue this for the full year audit (the company folded before this was done). In the circumstances of the New Cap transaction, we prefer the evidence of Mr Hulse to that of Mr Shanahan. Leg 1 was signed on 3 September 1998 and Leg 2 was signed a day later on 4 September. Total losses were assumed by all parties on both Legs which were intended to be reciprocal. It seems to us that the principle of "substance over form" so as to give a "true and fair" view to the users of the financial accounts must be the overriding one.

<u>New Cap – the role of Mr Vukelic</u>

93. The considerations we identified above apply equally to New Cap. But this was a transaction in which Mr Vukelic was more directly and closely involved. Viewing the contemporaneous records with all the caution which, as we have agreed at Paragraphs 27 and 28 above, to be appropriate and carefully considering Mr Vukelic's explanations we have to conclude that he knew full well that the objective of the transaction could not be achieved if the auditors were fully informed and that for that reason they would not be. There seems to us no plausible explanation for the existence of a substantial amount of material showing concealment to be the running assumption of Mr Vukelic and his colleagues. Once again, however, while recognising that the Authority has a strong case for contending that Mr Vukelic acted dishonestly we give Mr Vukelic the benefit of the doubt by concluding that there was a serious lack of integrity in that he must have turned a blind eye to the obvious.

94. This was a significant transaction with potentially far reaching consequences and Mr Vukelic's approach to it was at the least reckless rather than negligent.

We are sure that if he did not know, he had every reason to believe that the transaction was an improper one which would only work if the truth was concealed from the auditors. The best that can be said is that he knowingly took an unreasonable risk.

5 The Zurich Transaction

95. Zurich Australian Insurance Limited ("Zurich Australia") is a general insurance subsidiary of the well known Zurich Financial Services Group ("Zurich"). In February 2000, after the other two transactions which had taken place at around the same time, Zurich Australia told AltSol that it had severe 10 problems with its liability portfolio and was unlikely to meet its APRA solvency requirement. GCRA declined to provide a stop loss on a risk transfer basis. AltSol began to consider "*how we can solve the capital and commercial liability book problems in a tax efficient manner on a non risk basis*" (see Mr Ellingsen's e-mail of 22 February 2000). These discussions led to the 15 complex transaction that we summarise below which also had, potentially, Two Legs. The First Leg was a loss portfolio transfer contract ("The LPT") and its retrocession via Gen Re Group back to Zurich Bermuda. At first the retrocession was to have been to Bavarian Re, a company independent of the Zurich Group. The second leg was a stop loss contract and its retrocession, 20 also via Gen Re Group, back to Zurich Bermuda. It seems that the purpose was to inject regulatory capital into Zurich Australia through the use of reinsurance but the Authority claims that this would work only if there appeared to be insurance risk transfer and the intra-group relationship between Zurich Australia and Zurich Bermuda was concealed. Zurich Australia's 25 auditors were initially informed only of the LPT and when they learned of the stop loss they were not informed of the link between the two legs or that both were retroceded back to the Zurich Group. As a result of these transactions, Zurich Australia's profit in its audited accounts for 2000 was overstated by A$61 million.

30 96. The Authority claims that Mr Vukelic knew that there was no insurance risk in the Zurich transaction taken as a whole and that it was a single transaction, the net economic effect of which was that Gen Re/AltSol would receive a substantial fee where no insurance risk had been transferred. The Authority also contends that Mr Vukelic knew and understood the accounting need for 35 insurance risk transfer, and that if Zurich Australia's auditors knew and had the full picture, the LPT would not be accounted for as a reinsurance transaction. The Authority says that the overall structure was designed to facilitate concealment of parts of it from the auditors.

97. Mr Vukelic contends that whether or not the LPT and the stop loss are seen as 40 a single transaction there was a transfer of risk and both were genuine and legally enforceable contracts. Further, Mr Vukelic believed that Zurich Australia and other companies in the group would make full and proper disclosure to their auditors of both the LPT and, subsequently, the stop loss. He had no reason to believe that anyone would be misled.

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The contract structure

98. Again we start with the Authority's summary set out in its Statement of Case as this seems accurate.

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99. The LPT was a contract between Zurich Australia (as reinsured) and GCRA (as reinsurer). The key elements of the LPT and its retrocessions were as follows:

(1) Zurich Australia was to pay a premium of A$137.75 million and GCRA was to provide cover of A$254 million (with an excess of A$10 million). A$134 million of the premium of A$137.75 million was placed in an Investment Fund, which was to be used to pay Zurich Australia for claims arising under the LPT. Interest earned on the Investment Fund would also be used to pay claims;

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(2) on the face of the LPT, and considered in isolation, the cover of A$254 million is greater than the premium of A$137.75 million. On its face and in isolation therefore, the LPT appears to transfer insurance risk;

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(3) in the event that claims exceeded the amount of A$134 million placed in the Investment Fund (together with accrued interest), there would be a shortfall. It was anticipated that such a shortfall would be in the order of A$60 million and would occur in 2007;

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(4) although insurance risk was transferred to GCRA under the LPT, GCRA did not in fact retain any insurance risk, which was retroceded in its entirety to another part of the Zurich Group, namely Zurich Bermuda; and

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(5) although GCRA did not retain any insurance risk in relation to this transaction, it received a fee of A$3.5 million

100. The LPT had features, which, the Authority submits, even when considered in isolation, indicated a lack of genuine commerciality:

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(1) GCRA would have been, in the light of the value of anticipated claims (of around A$60 million), exposed to a gross loss in the order of A$65 million at inception;

(2) the contract was retrospective, which afforded GCRA the opportunity to evaluate the insurance risks to assist in pricing the contract. There is no evidence that GCRA did so; and

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(3) the premium for the LPT was arbitrary fixed with no apparent relation to the extent of the claims which were the subject matter of the LPT.

101. The Stop Loss was a contract between Zurich Australia (as reinsured) and CRAUS (as reinsurer). The main elements of the Stop Loss were as follows:

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(1) it was structured as an annual contract:

(a) *in 2000, Zurich Australia was to pay a premium of A$7.66 million (which was expected to adjust to earn A$8.3 million) and CRAUS was to provide cover of A$45 million;*

5 (b) *in 2001, Zurich Australia was to pay a premium of A$6.75 million and CRAUS was to provide cover of A$45 million;*

(c) *in 2002, Zurich Australia was to pay a premium of A$7.608 million and CRAUS was to provide cover of*
10 *A$45 million; and*

(d) *in 2003, Zurich Australia was to pay a premium of A$12.5 million and CRAUS was to provide cover of A$50 million.*

(2) *on its face, and considered in isolation, the cover is greater*
15 *than the premium. On its face and in isolation therefore the Stop Loss appears to transfer insurance risk;*

(3) *although insurance risk was transferred to CRAUS under the Stop Loss, CRAUS did not in fact retain any such risk which was retroceded in its entirety to another part of the Zurich*
20 *Group, namely Zurich Bermuda;*

(4) *although CRAUS did not retain any insurance risk in relation to the Stop Loss, it received a fee of around A$1.9 million; and*

(5) *from the outset CRAUS (and AltSol, including Mr Vukelic) and*
25 *Zurich Australia expected the Stop Loss to be claims free..*

102. The Stop Loss had features which, the Authority submits, even when viewed in isolation, indicated a lack of commerciality:

(1) the contract for the year 2000, ie that incepting on 1 January 2000, was signed in December 2000, after the expected result for the year would
30 have been largely known. On 19 December 2000 Zurich Australia paid a premium of A$7.66 million at a time when claims would have been anticipated to be nil;

(2) a double trigger mechanism, which made the probability of a claim arising on the contract extremely remote, was implemented from the
35 2000 year onwards. The first element of the trigger was a loss ratio set at 100%. When the contract was entered into, loss ratios were below this trigger level and were improving. The second element of the double trigger was a target investment return which was below the risk free interest rate. Both triggers therefore were set at levels which were
40 very unlikely to be hit;

(3) Zurich Australia did not seek to re-set the triggers annually (as it was able to do) and continued to pay premiums based on agreed rates, even

though it was apparent that this made no commercial sense on a stand-alone basis;

(4) despite an improving claims experience, the premium rates were increased. The underlying performance would have justified a reduction rather than an increase; and

(5) there is no evidence that CRAUS made any attempt to analyse projected losses or historical losses or to calculate a reasonable profit and expense allowance, suggesting that premiums and other policy conditions were not established on a stand-alone basis but were linked to another driver.

103. It seems that the Stop Loss was expected to be claims free so that the premiums paid by Zurich Australia would pay back any net losses sustained by the ultimate reinsurer, Zurich Bermuda. Zurich (either Bermuda or Zurich itself) would in effect provide Zurich Australia with capital to meet its solvency requirements in 2000 and be repaid over 6 years from the investment income on the premium on the LPT contract and the premiums on the claims free Stop Loss contract. As Mr Byrne put it in an e-mail dated 8 December 2000 copied to Mr Vukelic "*in summary this second deal has been put in place to facilitate Zurich Australia paying back to [Zurich Bermuda] losses that are expected to arise under the first contract*". The approval memorandum attached to that e-mail recorded that the "*purpose of this contract is to fund losses under the LPT….our fee for facilitating this payment is 5.5% of the premium paid to Zurich Australia and to the Stop Loss….the contract is expected to be loss free….the clear intention of this contract is to fund expected loss under the [LPT]*".

104. The expectation that the Stop Loss would be claims free arose from the fact that it was to pay only if "*the losses in excess of an attachment point of 100%...Net Incurred Loss Ratio up to 10%….what Net Premium of the current reinsurance year, if the Investment Income of the Reinsured is smaller than 7% of the Net Premium*". Neither of the double requirements was likely to be met. The 100% Net Loss Ratio would not be activated for 2000 when the Stop Loss was written in December. Mr Vukelic suggested in evidence that there was a possibility that the investment income might indeed shrink below 7% but accepted that claims were unlikely.

105. Mr Vukelic accepted that the LPT contract and the Stop Loss were related contracts and that both contracts and their relationship should have been disclosed to the auditors. On 1 September 2000 Mr Vukelic had been copied an e-mail from Mr Byrne explaining that Zurich had asked to complete leg one "*now they have asked us to re-structure it later in the year so that it can incorporate the planned payback by Zurich Australia so that from a Zurich Group perspective there is no major cross subsidisation to the Australian subsidiary*".

106. On 26 July 2000 Mr Byrne sent an e-mail to Mr Houldsworth, copied to Mr Vukelic, containing an extract from the Australian Accounting Standard FAS 113, Paragraph 8 of which emphasises the need for a complete understanding

of that contract and other contracts and agreements between the parties and Paragraph 58 of which states that a risk assumed by the reinsurer through one contract may have been offset by others and that a contract does not amount to reinsurance if features of it or other agreements directly or indirectly compensate the reinsurer for losses. A week later Mr Vukelic was told by Mr Byrne that Zurich Australia were due to have a meeting with the Regulator on 10 August 2000 and wanted a signed contract prior to then "*as it wants to include the contract's impact in its return to 30th June*". The Authority suggests that Mr Vukelic must therefore have been aware that Zurich Australia's regulatory returns to 30 June 2000 were likely to be misleading. When Zurich Australia drew up its statement for the year ended 31 December 2000 it took the LPT into account as reinsurance but did not disclose to its auditors its relationship with the Stop Loss. So, Zurich Australia's profit was overstated by A$61.457 million.

107. When, apparently in April 2004, the auditors of Zurich Australia learned of the relationship between the LPT and the Stop Loss, they were very concerned. As a result of discussion between the auditors and Zurich Australia, that company's accounts for the year ended 31 December 2004 contained a note describing a "fundamental error" in accounting for the LPT and the Stop Loss and this resulted in a substantial re-statement of the company's results for the period between 2000 and 2003.

Zurich – the position of Mr Vukelic

108. Mr Vukelic contends that there was clearly risk transfer under the LPT and that it was therefore capable of being accounted for as a reinsurance transaction. Under the LPT, A$3.5 million was received by GCRA, CRD and AltSol as a legitimate funding fee. Zurich Australia received an accounting benefit but also reinsurance cover. It did not need to mislead its auditors to obtain the accounting benefit and did not do so. Zurich Australia was not a party to the retrocessions. Similarly the Stop Loss transferred risk as there was a possibility of loss of around A$37 million in the first year and in subsequent ones. The trigger levels made it unlikely that there would be a loss but it remained a possibility. Reinsurance is frequently placed to cover unlikely if possible losses. Mr Vukelic submits that the evidence of Mr Ryan and Mr Shanahan should be accepted and that even Mr Hulse, the Authority's expert, concedes that there was a transfer of risk if the Stop Loss is considered in isolation.

109. Mr Vukelic relies on the fact that he was not party to any discussions between Zurich, its regulators and its advisers. In July 2000 when the LPT was being considered and in December 2000 he had no reason to believe from the approval memorandum or other information provided to him that the auditors were being or needed to be misled. He relies on the fact that if they wanted to conceal anything GCRA and AltSol would not have sought tax advice on the Stop Loss from PWC who are also Zurich Australia's auditors. The failures on the part of directors of the various Zurich companies should not be visited upon Mr Vukelic.

Expert evidence - Zurich

110. Mr Hulse maintained that the Stop Loss contract was entered into with the intention that it would operate as a payback mechanism for expected losses on the LPT contract. He said that the LPT contract signed in September 2000 could only have been accounted for as reinsurance, even at that time, if there was no evidence of a plan to effect payback. However, by December 2000 (which was Zurich Australia's financial year-end) the Stop Loss contract had been signed. This imposed a 'constructive obligation' on Zurich Australia to maintain payments until the deficit that arose on the LPT contract had been extinguished, even if it was not legally binding. Mr Hulse accepted that the definition of 'constructive obligation' was not adopted in Australia until AASB 1044 was issued in October 2001 but said that this standard had merely "*codified prior practice*". In cross examination, Mr Hulse agreed that 'payback' in the reinsurance industry is not unfamiliar but argued that it could not be binding and be no more than "*we have a gentleman's agreement that we'll do something, we'll see them right when the cycle improves*". In Mr Hulse's opinion the Zurich transactions should not have been treated as reinsurance in the accounts. His view was not altered by the fact that the contracts were retroceded and that the Stop Loss contract could, but in his view from all the documentary evidence was never intended to, be terminated annually.

111. Both Mr Ryan's and Mr Shanahan's witness statements maintained that the Stop Loss contract contained the risk of loss. In cross examination, Mr Ryan accepted that "*it was extremely unlikely*" that there would be a claim on the Stop Loss contract during 2000, given that the contract was signed on 11 December 2000; it had incepted on 1 January 2000; it had two trigger points which had not been pulled and he was also aware that Mr Byrne had said in January 2001 that the contract would not be hit. The Stop Loss contract had a long period of payback (originally calculated as 16 years by Mr Hulse, the period used by Mr Shanahan in his report before Mr Hulse revised it down to 5-7 years after taking account of investment income) and could be cancelled each year, so that it could not be considered to be binding. Mr Ryan contended that Zurich Australia's directors would have an obligation to policy holders to cease making payments if the company got into financial difficulties. Mr Shanahan believed there was sufficient credit risk from this arrangement (as to recovery of debt) to justify insurance accounting under AASB 1023. He also maintained that Zurich Australia was not a legal party to the retrocession arrangements that CRD and CRAUS made ultimately with Zurich Bermuda (after Bavarian Re declined to do the business in September 2000). While Mr Ryan and Mr Shanahan may have been correct if CRD and CRAUS had ceded the risks to a company independent of Zurich Australia, Zurich Bermuda was part of the same corporate group. We consider that Mr Ryan and Mr Shanahan gave insufficient weight to this. We agree with Mr

Hulse's opinion that it was not intended that the Stop Loss contract would be cancelled before payback was made and that this transaction should have been treated as financial reinsurance.

5 112. In preferring Mr Hulse's evidence that the transaction should not have been insurance accounted, the Tribunal also had the benefit of seeing the accounts of Zurich Financial Services Australia Limited for the year ended 31 December 2004, which described the fundamental error in accounting for these contracts, and the Inspector's Report to APRA.

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113. The boards of Zurich Australian Insurance Limited (ZAIL) and its parent company (Zurich Financial Services Australia Ltd) determined in November 2004 that the Loss Portfolio Transfer and Stop Loss contract ought properly to have been characterised as financial reinsurance in accordance with
15 accounting standards having the force of law under Corporations Law and Corporations Act 2001 as it did not involve the transfer of risk from ZAIL. Note 3(d) to the annual report and accounts of Zurich Financial Services Australia Limited for the year ended 31 December 2004 describes the fundamental error in accounting for the contracts. Under AASB1018 the
20 financial impact of the fundamental error can only be recognised in the period in which the error is discovered. The cumulative effect of the fundamental error over the years from 2000 to 2003 is to reduce the profit (and assets) for 2004 by A$1,005,000 (see the Zurich Financial Statement for 2004) arising from an increase in income tax expense. However, the note also states the
25 company failed to account properly in 2000 and subsequent years. Profit after tax was overstated by A$61.5 million in 2000, which represents a significant reduction in profit of 15 per cent (from A$408.8mn to A$347.3mn). Profit after tax was understated by A$9.7million in 2001 and understated by A$20.0million in 2002. Total assets in 2000 would also have been overstated.

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114. The Inspector's Report to APRA dated 1 July 2005 noted that without the A$61 million 'profit' generated from the LPT, Zurich Australia would have failed the APRA minimum solvency level and its credit rating may have been downgraded from A+ to BBB+.

35 Zurich Conclusion

115. Mr Vukelic was clearly aware of the Zurich transaction and accepted in interview with the FSA that he was "*probably more involved in terms of looking at what was going on in Zurich than I would have been in another deal…*" The transaction was also very large. Mr Vukelic knew from an e-
40 mail of 30 May 2000 that this was another deal with two legs with the Stop Loss being put in place but well after the LPT. An e-mail of 27 June made it clear to Mr Vukelic that there was "*no attractive Risk Transfer solution to the problem*". On 5 July Mr Vukelic received an e-mail from Mr Byrne attaching an e-mail from the auditors PWC "(PWC) *still do not understand the*
45 *commercial substance of the transaction*". PWC asked about the premium

describing it as a "*fundamental question"* which *"....may resolve any remaining issues surrounding the accounting for the transaction when properly understood by us*". They were asking for all documentation supporting the proposed transaction. Mr Byrne's e-mail recorded "*met PWC and all's on track (I hope) local CFO was a little economical with the truth when he told us earlier in the week that PWC had signed off*". There is no evidence that Mr Vukelic pursued this in any way.

116. On 26 July 2000 the e-mail from Mr Byrne copied to Mr Vukelic set out Para's 8 and 58 of the FBS 113 "*it seems the issue was down to the interpretation of Para's A and 58 of FSA 113 which deal with the need to look at all contracts associated with a deal to decide whether a contract contains risk. I won't quote the detail to you but there are two key sentences*".

117. An e-mail of 24 October sent to Mr Vukelic describes the Stop Loss as being a "*pay back mechanism for the LPT with us*".

118. Given the background of the earlier transactions and the e-mails relating to this particular one it is clear, as Mr Vukelic accepts, that he knew the transactions were linked. He also knew that consideration of risk for either part of the transaction required both limbs to be evaluated together and as a whole. Whatever the theoretical possibilities it is obvious to us, as a matter of common sense, that these transactions would not transfer risk. That was not their purpose. Indeed the company's restated accounts, which we have no reason to dispute, make the position clear. It is improbable that the company would have accepted the need to restate unless it was satisfied that it had to do so. Further Altsol, or rather GCRA, had ruled out the possibility of taking on a risk bearing deal as the e-mails show and as soon as the auditors learned of what they should have been told at the outset they were horrified. Reconstruction after the event to suggest that the transactions were legitimate is unconvincing. It is possible to construct an argument that the transactions were capable of being independent and self standing each carrying its own commercial incentive and purpose. But these arguments fall down when one appreciates that the risks were very remote if they existed at all and that the intention was that the transactions should be linked and not carry risk.

119. Mr Vukelic knew or should have known that the scheme would fail if the auditors learned the whole truth. The fact that the duty to disclose fell on others not on Altsol or GCRA does not excuse his involvement in a scheme which everybody knew or should have known depended for its success on a want of candour. It may be that Mr Vukelic was not dishonest on this transaction in the sense of deliberately participating in a scheme to deceive and we are prepared to accept that he was not. But he turned a blind eye to what was obvious and failed to follow up obviously suspicious signs. We do not believe that an educated professional in a senior position could have been oblivious to the signs that the transaction depended on concealment for its success. It is possible, but unlikely, that Mr Vukelic simply failed to spot what should have been obvious to a person in his position. But if that had been so it would have resulted from an inexcusable failure to ask obvious questions.

Further submissions of the Authority

120. Mr Philipps suggested that Mr Vukelic's attempts in evidence to justify these transactions were opportunistic and inconsistent. FAI is justified by the need to look at the legs in their totality but New Cap is alright if the legs are isolated from one another while the propriety of Zurich springs from the fact that leg two did not create a binding obligation. Mr Philipps urged findings of dishonesty.

Further submissions of Mr Vukelic

121. Mr Flint urged that, as the transactions were in grey areas, the Authority could not show dishonesty. Financial reinsurance is not in itself improper nor is a deal done in expectation of payback. There is nothing in itself improper in a financial reinsurance being structured to produce an accounting benefit. The Australian accounting provisions were 'grey'. It was for the auditors to determine how a transaction should be accounted for in discussion with their clients. It was ultimately for the company to determine what was presented to its auditors and his client should not be found to be responsible for this.

Conclusions on the Applicant's role.

122. As CEO of AltSol Mr Vukelic had overall responsibility for the transactions. In each case he chose not to exercise his power of veto to stop what should have been seen to be an obviously questionable deal from going ahead. There is little evidence that he questioned these deals at all or discussed them with his superiors. Further he played an active role in the negotiation and implementation of the transactions and was reckless as to whether they were intended to mislead auditors and others. We find that he must have appreciated that the deals would probably founder if they were fairly and fully described to auditors and others with a right to know. His conduct in relation to these transactions lacked integrity and was partly responsible for the very serious consequences described above, in particular with FAI and NewCap. In terms of the consequences for creditors, investors and shareholders, it made little difference whether Mr Vukelic was dishonest or merely reckless. It was of some concern to the Tribunal that Mr Vukelic, while regretting in retrospect his role in these transactions, did not appear to have appreciated the seriousness of his shortcomings in relation to them.

123. It seems to us that there is an important misunderstanding about the responsibilities of regulatory compliance lying behind the case so ably presented on Mr Vukelic's behalf. Anyone who promotes financial products on the basis that a clear potential for abuse is not their problem because primary responsibility for disclosure to auditors, regulators or others rests with the client, is, as we see it, acting unethically and can expect appropriate regulatory sanctions.

124. We agreed with Mr Flint's submission that it would be fairer for points he wished to make on his client's behalf on the question of 'fit and proper' to be developed in the knowledge of the Tribunal's findings on the matters we have addressed so far. We therefore released this draft Decision in confidence to the

parties before what we suggested should be short further written submissions from each side or a brief further hearing.

Hearing on 13 March 2009

125. Mr Bagge for the Applicant submitted that an unlimited prohibition order as sought by the Authority would be disproportionate in view in particular of the absence of risk Mr Vukelic presented to the statutory objectives, his mitigating circumstances and the impact which this would have on his ability to earn a living. Mr Vukelic was not a risk, he had not been found to be dishonest and these lapses had occurred eight to ten years ago. He had assumed a senior role in an unfamiliar field and was entitled to place some reliance on colleagues. While he had defended the case all along, his honesty had been at stake. His conduct both before and after these events had been impeccable. Mr Bagge produced impressive written testimonials and Mr Michael Watson, CEO of a private insurance business for which Mr Vukelic has been working as a consultant, spoke very highly of his integrity. We were also taken to comparable decisions in other cases. Mr Vukelic addressed the Tribunal and informed us that he now accepted that the transactions had been improper and that he had been reckless. He accepted all the findings of the Tribunal, regretted his role very much and apologised for his shortcomings.

126. Mr Phillipps for the Authority submitted that a full prohibition was essential for market confidence. Any lesser penalty would send out a dangerous message and damage confidence. These large and damaging transactions could not have gone ahead without Mr Vukelic's want of integrity. Further Mr Vukelic had consistently failed to recognise that this was much more than a management failing. Moreover he had sought to justify each transaction right up to the last minute despite the overwhelming evidence and the views formed by other regulators and similar bodies.

127. While we welcome Mr Vukelic's change of heart, albeit at the very last minute and after considerable public and private resources have been spent, and recognise the force of his personal mitigation, these lapses were very serious in terms of the need for market confidence and consumer protection and had very great financial consequences. Mr Vukelic cannot be penalised for exercising his rights to fight this case but neither can he claim the credit due to those who acknowledge their failings. The RDC did not find Mr Vukelic to be dishonest so he did not need to challenge their decision on that ground. Further a persistent failure to recognise shortcomings is a particularly important consideration in a regulatory case where an applicant claims the right to continue to function in a position of trust. As the Tribunal considers matters afresh on the basis of much more evidence than is considered by the RDC we are not directly concerned with their Decision. Nevertheless we consider their Decision in this case to have been careful, fair and appropriate. We conclude that Mr Vukelic is not 'fit and proper' within Section 56 of the Act and that there should be an order prohibiting him from performing any function in relation to any regulated activity carried on by any authorised or exempt person or exempt professional firm.

HIS HONOUR JUDGE MACKIE CBE, QC
CHAIRMAN

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