Insurance/
Reinsurance

May
2015

AN UPDATE ON DIRECTORS AND OFFICERS LIABILITIES

Overview of new Senior Managers Regime for financial institutions

The roles of Directors and Officers (D&O) within companies are increasingly being scrutinised and further liabilities and responsibilities are being identified. Recent regimes, regulations and statutes have focused on:

- The role of Senior Managers within financial institutions.
- The making of compensation orders pursuant to the Small Business, Enterprise and Employment Act 2015.

This Briefing discusses these new developments and what they mean for the individuals who may be the subject of scrutiny, and the insurers who underwrite D&O coverages.

Background

The Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) are proposing changes to the regulatory regime for senior bankers in the UK in order to "make individual responsibility in banking a reality" in the words of the report of the Parliamentary Commission on Banking Standards whose recommendations formed the basis of the new regime. This included:

- The role of the behaviour and culture within banks and its effect on the 2008-09 financial crisis.
- The PPI mis-selling scandal.
- The manipulation of LIBOR.
- Failings in respect of the spot foreign exchange market.

The statutory and regulatory framework in place had been inadequate. It did not clearly provide for individual accountability and consequently public trust was lost in the banking system and its regulation. Initially, the Parliamentary Commission on Banking Standards recommended making amendments to the Financial Services and Markets Act 2000. This was effected through the Financial Services (Banking Reform) Act 2013 which introduced structural reform of the banking

holman fenwick willan hfw

industry and measures aiming to increase the capacity of banks to absorb losses. The new Senior Managers Regime is the next step in the new regime.

In July 2014, the PRA and FCA published joint consultation paper CP14/14, which proposed the following changes:

- A new Senior Managers Regime (SMR) for the most senior people working in banks.
- A Certification Regime that applies to a larger number of individuals who could potentially harm the firm or its customers.
- New Conduct Rules, divided between those which apply to all non-ancillary staff and those which apply only to senior managers.

This Briefing focuses on the SMR.

The proposals apply to UK-incorporated banks and investment banks. HM Treasury may also expand the scope of the regime to non-UK-incorporated banks and investment banks.

SMR – principal changes

- Chairmen and non-executive directors (NEDs) will be included as "Senior Management Functions" (SMFs): the SMR amends the current FCA Approved Persons Regime and intends to focus accountability on a smaller number of senior individuals in a bank. This means that not all of those currently holding a "Significant Influence Function" are expected to be SMFs under the SMR. This change will cause those with SMFs to be explicitly held to account for boardroom decisions and held culpable for any poor decisions.
- "Prescribed Responsibilities" will be introduced: firms will need to allocate clear lists of responsibilities to the most senior individuals performing SMFs. This list must reflect the responsibilities outlined in the FCA Handbook and PRA Rules and will be tailored to the governance structure of each firm. Once prepared, "Statements of Responsibilities" will need to be provided to the FCA and PRA as part of any application for approval. When jobs change, senior managers must formally hand over their "Statement of Responsibilities".
- A "Management Responsibilities Map" will be introduced: both the PRA and FCA will need to map the responsibilities and reporting structures within each firm in a single document called the "Management Responsibilities Map". This will include showing how the "Statements of Responsibilities" have been allocated. The measure is designed to highlight where areas of responsibility are shared, missing or unclear. Each firm's board must provide annual confirmation to the regulators that there are no gaps in the allocation of responsibilities within the firm.
- Reversal of burden of proof: until now, a regulatory breach by a firm only implied misconduct by an individual if the individual was "knowingly concerned" or in breach of statements of principle for approved persons. The new SMR changes this position radically. Now, if a breach occurs in an area for which a particular senior person is responsible, that person is guilty of misconduct unless he can show he took reasonable steps to avoid the breach. The burden of proof will therefore be reversed and fall upon the senior manager to show his innocence. Thus, it will be vital for senior mangers to ensure appropriate systems and controls are in place, such as appropriate reporting lines and management information arrangements.
- Duty to notify the regulator if disciplinary action occurs: firms must notify the regulator if it takes disciplinary action against a senior person, so that the regulator can decide whether it should also take action against that person. "Disciplinary action" includes issuing a formal written warning, suspending or dismissing the senior individual or recovering any of their remuneration.
- Annual review: firms will be required to formally review, at least once a year, whether there are any grounds on which the PRA or FCA could withdraw its approval of a senior person. If it believes there might be such grounds, it must notify the regulator.
- Extended time limits for disciplinary action from three to six years: the time limit for disciplinary action by the PRA or FCA where a person commits misconduct or carries out his functions without obtaining the required approval from the relevant regulator has been extended from three years to six years. This date runs from the date upon which the regulator first knew of the misconduct, or the date the person began performing the relevant functions.
- "Group Entity Senior Manager" will be introduced: this will be introduced to bring those employed by a parent, group or holding

HM Treasury has announced that the new regime will need to come into force by 7 March 2016. The FCA and PRA therefore plan to publish final rules in either the late spring or summer of 2015.

JOHN BARLOW, PARTNER

company that exercises significant influence over activities in the UK into the scope of the regime. This is the case whether the parent company is based in the UK or overseas.

Current status

As stated above, the FCA and PRA issued their consultation paper CP14/14 in July 2014. They stated that they would consider feedback on responses received to this paper.

On 16 March 2015, the FCA and PRA published consultation paper CP15/9, in which they set out their policy intentions as a result of the feedback received.

HM Treasury has announced that the new regime will need to come into force by 7 March 2016. The FCA and PRA therefore plan to publish final rules in either the late spring or summer of 2015.

In the meantime, the FCA invites firms to provide comments on its proposals by 16 June 2015 using their online response form at http://www.fca.org.uk/your-fca/documents/consultation-papers/cp15-09-response-form.

Insurers' response

What does this then mean for D&O insurers?

- The Prescribed Responsibilities and the Management Responsibilities Map will give insurers a far more detailed overview of the activities of certain directors and officers.
- The reversal of the burden of proof is likely to lead to a considerable increase in legal costs given that the director is required to prove his innocence where a prima facie breach occurs in an area for which that individual was responsible.
- The time limits for disciplinary actions has been doubled from three to six years.

What are the new director compensation orders that the Small Business, Enterprise and Employment Act 2015 will introduce into the Company Disqualification Act 1986?

In general terms, section 110 of the Small Business, Enterprise and Employment Act 2015 (the 2015 Act) amends the provisions of the Company Director Disqualification Act 1986 (the CDDA 1986) in relation to directors' disqualification.

One of the changes introduced is that the Secretary of State will be able to apply to the court for a compensation order against a director who has been disqualified where creditors have suffered identifiable losses from the director's misconduct[1].

A "compensation order" is an order requiring the person against whom it is made to pay an amount to the Secretary of State for the benefit of creditor(s) or a class of creditor(s) as a contribution to the assets of company (amended section 15B(a) of the CDDA 1986).

The Secretary of State can apply for the compensation order within 2 years of a disqualification order being made against a director (amended section 15A(5) of the CDDA 1986).

Factors to be taken into account in determining the amount to be paid under a compensation order are:


- The amount of the loss caused.
- The nature of the director's conduct.
- Whether the director has made any other financial contribution in recompense for the conduct.

Alternatively, the Secretary of State may accept a "compensation undertaking" from the relevant director instead of applying for a compensation order (amended section 15A(2) of the CDDA 1986). A "compensation undertaking" is an undertaking to pay an amount specified in the undertaking to the Secretary of State for the benefit of a creditor or class of creditors as a contribution to the assets of the relevant company (amended section 15B(2) of the CDDA 1986).

Comparison with the Insolvency Act 1986

Prima facie, the compensation orders introduced by the 2015 Act appear remarkably similar to sections 212 to 214 of the Insolvency Act 1986 (IA 1986), which allow liquidators to apply to the court for an order that directors contribute to the assets of the insolvent company:

- IA 1986 at section 212 provides that an action may be brought against someone who *"is or has been an officer"* of the company, if the company in which they held office is wound up. In these circumstances, a liquidator, shareholder or creditor can bring an action if that individual has *"misapplied or retained, or become accountable for, any money or other property of the company or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company"*.
- IA 1986 at section 213(2) deals with fraudulent trading and provides that on the application of the liquidator, the court may declare that any persons who were knowingly parties to the carrying on of the business fraudulently are liable to make such contributions to the company's assets as the court thinks proper. *"Fraudulent"* is defined in section 213(1) as carrying on company business *"with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose"*.
- IA 1986 at section 214 deals with *"wrongful"* trading. As with fraudulent trading, the liquidator can apply to the court for a declaration to make a contribution to the company's assets. The conditions for *"wrongful trading"* are defined in section 214(2): the company must be in insolvent liquidation and an individual who was a director of the company at that time knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation. There is a defence at section 214(3) if the relevant director *"took every step with a view to minimising the potential loss to the company's creditors"*.

The principal difference between the IA 1986 and 2015 Act is that the 2015 Act does not specify that any *"wrongful"* or *"fraudulent"* activities are required in order for the application for compensation to be made. It merely requires a person subject to a disqualification order to have caused loss to creditors. Therefore, conduct might warrant disqualification and give rise to a claim for a compensation order under the 2015 Act, even though it might not reach the threshold of sections 213 or 214 in the IA 1986. For instance, disqualification for failure to maintain proper books and records.

However, in practice, it is difficult to imagine many situations where the Secretary of State would apply for a compensation order without an element of wrongful or fraudulent trading having been committed by directors.

The new Insolvency Rules are expected to come into force in April 2016. It is possible that the director compensation orders will be incorporated into these Rules given their similarity to the provisions of the current IA 1986.

What is the potential impact of the new director compensation orders upon D&O insurance?

There is some uncertainty as to coverage of D&O insurance if a director is subject to a compensation order made under the 2015 Act. However, in general terms it may be assumed that:

- In the case of a compensation order for *"wrongful"* trading (i.e. a section 214 IA 1986 situation), D&O insurance would likely cover the order if it related to merely negligent activity.
- In the case of a compensation order for *"fraudulent"* trading (i.e. a section 213 IA 1986 situation), D&O insurance would typically exclude fraud and therefore not cover the order.

1 The 2015 Act states that *"the conditions are that –*
(a) the person is subject to a disqualification order or disqualification undertaking under this Act, and
(b) conduct for which the person is subject to the order or undertaking has caused loss to one or more creditors of an insolvent company of which the person has at any time been a director."



For more information, please contact the author of this Briefing:

John Barlow
Partner, London
T: +44 (0)20 7264 8188
E: john.barlow@hfw.com

HFW's London office is part of an international network of 13 offices in 11 countries. For further information about insurance/reinsurance issues in other jurisdictions, please contact:

Richard Spiller
Partner, London
T: +44 (0)20 7264 8770
E: richard.spiller@hfw.com

Olivier Purcell
Partner, Paris
T: +33 1 44 94 40 50
E: olivier.purcell@hfw.com

Pierre Frühling
Partner, Brussels
T: +32 (0) 2643 3406
E: pierre.fruhling@hfw.com

Jeremy Davies
Partner, Geneva
T: +41 (0) 22 322 4810
E: jeremy.davies@hfw.com

Dimitri Vassos
Partner, Piraeus
T: +30 210 429 3978
E: dimitri.vassos@hfw.com

Sam Wakerley
Partner, Dubai
T: +971 4 423 0530
E: sam.wakerley@hfw.com

Mert Hifzi
Partner, Singapore
T: +65 6411 5303
E: mert.hifzi@hfw.com

Henry Fung
Partner, Hong Kong/Shanghai
T: +852 3983 7788/
+86 21 2080 1000
E: henry.fung@hfw.com

Paul Hatzer
Partner, Hong Kong
T: +852 3983 7666
E: paul.hatzer@hfw.com

Richard Jowett
Partner, Melbourne
T: +61 (0) 3 8601 4521
E: richard.jowett@hfw.com

Andrew Dunn
Partner, Sydney
T: +61 (0)2 9320 4603
E: andrew.dunn@hfw.com

Hazel Brewer
Partner, Perth
T: +61 (0)8 9422 4702
E: hazel.brewer@hfw.com

Geoffrey Conlin
Partner, São Paulo
T: +55 (11) 3179 2902
E: geoffrey.conlin@hfw.com

Lawyers for international commerce

hfw.com

São Paulo London Paris Brussels Geneva Piraeus Dubai Shanghai Hong Kong Singapore Melbourne Sydney Perth