

## NEWSSTAND

Directors' Duties: Taking Responsibility

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In our previous article in the December 2007 issue, we wrote about the codification of directors' duties under English law into "general duties" under the Companies Act 2006 (the 2006 Act). All sections of the 2006 Act (Part 10) relating to directors' duties have since been implemented. In the present financial climate, there is a renewed emphasis on directors' general duties under the 2006 Act and on their obligations under the Financial Services Authority's (FSA) "approved persons" regime. This article highlights a director's individual responsibility in complying with those duties and obligations.

### **Duties Under the 2006 Act**

Section 170 of the 2006 Act makes clear that the general duties of directors, as codified in the 2006 Act, are derived from the previous equitable and common law rules. The codification is not only intended to provide greater clarity about what is required of directors and to make the law more accessible and easier for directors to understand, but also to make developments in the law of directors' duties more predictable. To what extent this proves to be correct will depend on future case law.

There is no doubt that over time we will see new case law clarifying the meaning of the general duties. Prime areas for clarificatory case law are the new duty to promote the success of the company for the benefit of its members (section 172 of the 2006 Act), and the new procedures for dealing with conflicts of interest (sections 175, 177 and 182 of the 2006 Act). Directors should keep abreast of developments in the case law in order to avoid breaching their general duties inadvertently.

The consequences of breaching the general duties under the 2006 Act are broadly the same as for a breach of the corresponding common law. Consequently, directors may face removal from office; imposition of civil and criminal penalties; personal liability for their acts or omissions; or to protect the public interest, may be disqualified from acting as a director (for up to 15 years) if found unfit.

The general duties under the 2006 Act are duties owed by directors to the company of which they are a director; in the majority of instances it is the company which will take action in respect of any breach of the general duties. Even where a shareholder brings a derivative action pursuant to section 11 of the 2006 Act, the right of action must reside with the company and the relief must be sought on behalf of the company. The 2006 Act does not however represent the whole picture for the directors of an FSA-regulated firm; such directors must also comply with FSA rules which govern the director's relationship with the FSA and customers of the regulated firm.

## **Senior Management Responsibility**

The FSA's supervision and enforcement powers use individual responsibility and accountability as a core feature. Indeed, senior management responsibility has been a fundamental feature of the regulatory regime introduced by the Financial Services and Markets Act 2000 (FSMA 2000). The perceived shortcomings in the governance and risk management of some regulated firms, which were exposed by the current economic crisis, are only likely to reinforce the FSA's propensity to hold senior management responsible.

The premise is that individuals with significant responsibility should be fit for the positions they hold, and so will be held to account for any failure to maintain the standards set by the FSA. The FSA seeks to achieve this through its approved persons regime.

## ***Approved Persons Regime***

Under the FSMA 2000 authorised firms must ensure that individuals who carry out so called "controlled functions" (certain key functions carried on in relation to regulatory activities specified in section 59 of the FSMA 2000) obtain approval from the FSA before performing such functions. After coming under much criticism following the onset of the financial crisis, the FSA is keen to assert an overtly strong regulatory approach.

In order to be approved to perform a controlled function an individual must for the duration of his performance of that function:

- satisfy the FSA that he can meet and maintain the criteria for approval (the fit and proper test); and
- perform his controlled function in accordance with a set of standards (the Statements of Principle and the related Code of Approved Persons (identified as APER in the High Level Standards Section of the FSA Handbook)).

## ***Controlled Functions***

All directors must be approved to perform the director function and non-executive directors must be approved to perform the non-executive director function. Other "significant influence" functions (certain of the "controlled functions" which involve the person performing them exercising significant influence over the firm and its regulatory affairs) include the chief executive function; apportionment (see below for an explanation) and oversight; compliance oversight; actuarial function; systems and control function; and the significant management function.

## ***The Fit and Proper Test***

The fit and proper test is the benchmark used by the FSA to assess an individual's suitability to perform a controlled function. The most important considerations for individuals are:

- honesty, integrity and reputation
- competence and capability
- financial soundness.

The Statements of Principle (the Statements) require approved persons to act with integrity (Statement 1), with due skill, care and diligence (Statement 2) and to observe proper standards of

market conduct (Statement 3). They must also deal with the regulator in an open and fair way (Statement 4). The related Code of Practice helps determine whether or not an approved person is compliant with the Statements.

### ***Senior Management Arrangements, Systems and Controls***

The FSA considers that having a single coherent framework in relation to the training and competence of staff working within the financial services industry, including insurance, is an essential component of the UK financial services regulatory regime. Having properly trained and educated staff not only makes good business sense but from the FSA's perspective it reduces the risks posed to consumers for example, by reducing the chance of mis-selling. Firms must ensure that their employees have the necessary skills, knowledge and expertise for the discharge of the responsibilities allocated to them (Section 5.1.1R of The Senior Management Arrangements, Systems and Controls Handbook (SYSC Handbook)). Senior management will be responsible for ensuring that employees are assessed prior to recruitment and regularly throughout their employment.

Firms must also take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers (SYSC 2.1.1R) and they must establish and maintain appropriate systems and controls for their business (SYSC 3.1.1R). It is the senior management of firms who will be held responsible if firms fail to comply with these regulatory obligations.

### **Recent Developments**

Several extensions to the scope of the approved person regime came into force in August 2009 with a six month transitional period to 6 February 2010 in order to give firms time to comply with the extended rules. The director (CF1) and non-executive director (CF2) controlled functions now include directors and non-executive directors of an unregulated parent whose decisions, opinions and actions are regularly taken into account by the governing body of an FSA authorised firm and are therefore likely to have a significant influence on the conduct of the authorised firm's affairs.

Insurance firms will therefore be required to expend time assessing which additional individuals in the group need to be approved persons of regulated firms. Applications will need to be made for approval and individuals will need to be trained to ensure they understand the ongoing regulatory consequences of being an approved person. In addition the approved person regime has been extended so that the majority of the controlled functions apply to UK branches of non-EEA firms.

Since 2008 the FSA has become increasingly involved in the hiring by firms of senior management, in particular by interviewing potential recruits. In October 2009 the FSA issued a "Dear CEO" letter (a letter to all chief executive officers of regulated firms) clarifying its approach to approving and supervising those carrying out significant influence functions. The FSA expects that "high impact" firms recruiting a new chairman, chief executive or senior independent executive will engage with the FSA early on in the recruitment process. As interviews will only take place after receipt by the FSA of a fully completed form, firms need to bear this in mind when recruiting to fill vacant positions and when making appointments to

newly acquired businesses. It is incumbent on firms to provide sufficient information to the FSA to satisfy it of the “fitness and propriety” of a potential candidate. In connection with those already carrying out significant influence functions, the FSA proposes to assess critically the competence of such individuals during ARROW visits.

### **Discipline and Sanctions**

An approved person is guilty of misconduct if he or she has failed to comply with a Statement or if the relevant authorised firm has knowingly contravened a requirement imposed on the firm by the FSA. Based on the approved person’s misconduct, the FSA may issue a private warning, a fine, public censure and/or ban an individual from performing a controlled function. Factors the FSA may take into account when deciding whether to take disciplinary measures against an approved person include:

- the approved person’s position and responsibility
- whether disciplinary action against the firm rather than the approved person would be a more appropriate regulatory response
- whether disciplinary action would be a proportionate response.

The FSA has stated that it will use enforcement action against firms or individuals as a strategic “credible deterrence” tool. The FSA is not reticent to use these powers and there are numerous examples of the FSA imposing bans on individuals exercising significant influence functions, recent examples include:

- The ban of two directors of the insurance broker, FHI (Northern) Limited, for three years from performing significant influence functions or carrying out regulatory activities, for failing to ensure their firm complied with the FSA client money rules (November 2008).
- The prohibition of Graham Darby, director of insurance broker Ambrose Darby, for failing to control the business of the firm adequately. The order banned Darby from performing significant influence functions at any authorised financial firm. A winding up order was also granted in relation to the firm (July 2009).

The FSA fined both the firm and members of senior management for failure to implement adequate systems and controls in an action taken against Land of Leather (for failure to train staff adequately to sell payment protection insurance) and a separate action taken against Sindicatum Holdings Limited (for failure to have adequate anti-money laundering systems and controls in place). Both actions evidence the FSA’s enforcement philosophy of individual responsibility and accountability.

Repeat regulatory breaches, for example in the payment protection insurance market, have led the FSA to believe larger fines are necessary to achieve its deterrence aim. Hence in its consultation paper CP09/19 “Enforcing Financial Penalties” the FSA proposed much larger fines, in some instances treble those that are currently issued. The FSA hopes that the increased probability of enforcement action together with larger fines should encourage better governance, improved competence and ultimately better outcomes for consumers.

### **Conclusion**

Insurance firms need to be aware of their duties under the 2006 Act and must meet the standards

required of their senior executives under the FSA's approved persons regime. Whilst individual responsibility and accountability have always been a core part of the FSA's approved persons regime, in the wake of the financial crisis compliance is being assessed and breaches enforced with renewed vigour. Never has it been more important for the senior management of insurance firms to ensure that they are fully aware of their duties under the 2006 Act and under FSA regulation, through appropriate advice, training, circulation of information and other methods.