

# Extension of UK SM&CR: Significant D&O Insurance Implications

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Insurance / Financial Services Regulatory

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From December 9, 2019, the Senior Managers & Certification Regime (“SM&CR”) will apply to all FSMA-authorized firms in the UK.<sup>1</sup> This extension of the SM&CR to an additional 47,000 firms is predicted to increase regulatory, investigative and enforcement focus on individuals, including by expanding the number of individuals targeted. However, it is unlikely to relieve firms of concurrent enforcement risk. Regulatory investigations are therefore, now even more likely to be multi-headed.

Relevant Directors’ and Officers’ (“D&O”) insurance cover must be available and able to respond to the more extensive risk scenarios. Companies and individuals taking out D&O insurance need to have certain key issues in mind when placing and renewing D&O insurance cover or making claims under such cover.

## The Senior Managers’ & Certification Regime

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The SM&CR places greater regulatory responsibility on individuals performing a “senior management function”. This definition covers the most senior staff in FSMA-authorized firms, who have the greatest potential to cause harm or impact market integrity, including CEOs, CFOs, NEDs and Chief Risk Officers.

When breaches of rules arise, the Financial Conduct Authority (“FCA”) will examine which senior manager was responsible for the area affected, and whether they took reasonable steps to prevent the breaches. On September 24, 2019, the FCA Director of Supervision for Investment, Wholesale and Specialist, Megan Butler, speaking at the Financial Times Investment Summit in London, reported that “*we’ve seen instances in recent months where if we had seen stronger levels of personal accountability it might have led to different outcomes*”. The 2018/19 FCA Annual Enforcement Report references some high profile enforcement

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<sup>1</sup> FSMA authorized firms include banks, building societies, asset managers, investment firms, insurers, mortgage providers, consumer credit firms and sole traders.

actions against individuals, disclosing a very significant increase in the total value of fines imposed on individuals, since the previous year.<sup>2</sup>

Under the SM&CR, the FCA can launch parallel investigations into both the firms and the individuals. It may impose dual fines both on the firms themselves and on the senior managers responsible for signing off on certain (non-compliant) decisions.

The new regime aims to simplify regulatory enforcement by requiring firms to prepare a “Statement of Responsibilities” for each senior manager, stating what the senior manager is responsible and accountable for, as part of their Controlled Function. This Statement must be kept up to date and re-submitted if there is a significant change in responsibilities. Firms must also prepare a “Management Responsibilities Map” setting out the firm’s management and governance arrangements, describing how responsibilities have been allocated across the firm. This must also be kept up to date and confirmed annually to the FCA, helping the FCA identify who the designated responsible senior manager is for particular issues.

Where a firm breaches a FCA requirement, the senior manager responsible for the relevant area could be held personally accountable (under a Duty of Responsibility) for failing to take reasonable steps to prevent the breach. The burden of proof will lie with the FCA to show that the senior manager did not take the steps that a person in their position could reasonably be expected to take to avoid the breach occurring. When deciding on the need for regulatory investigations and enforcement actions, the FCA will take into account the seriousness of the breach, the senior manager’s position, Statement of Responsibilities, the Management Responsibilities Map, and firm-wide operations.

## **D&O Insurance Implications**

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A London insurance market D&O policy will generally provide the following coverage for financial liabilities that individuals and firms may incur, as a result of regulatory action or proceedings triggered by such action.

First, the policy will usually cover the costs of an individual responding to and/or defending investigations, regulatory claims or connected civil proceedings. It will also cover civil damages awarded against an individual in connected civil proceedings. FCA regulations forbid insurance cover for FCA penalties, however, and a D&O policy will in also, in any event, not cover criminal fines or penalties. Any costs, penalties or damages paid by insurers will generally be repayable if an individual is found guilty of/liable for a deliberate or criminal act, or admits such guilt or liability.

The policy will also generally cover the firm’s liability to indemnify the individual for any of the costs, damages, fines and penalties referred to above, to the extent that the law permits such indemnity. Furthermore, it may provide cover for the firm’s liability to third parties in respect of related matters, for example, securities class actions. Increasingly, policies also cover specified

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<sup>2</sup> For instance, Paul Flowers, former Chair of Co-op Bank, James Staley, CEO of Barclays and Mohammed Proddhan, CEO of Sonali Bank (UK) Limited. Note the figures are somewhat skewed due to fines relating to Keydata.

emerging liabilities of individual directors and officers, such as cyber security and sexual misconduct.

The SM&CR regime creates certain issues that need to be dealt with when D&O cover is renewed, or new cover is placed. They include the following:

- The definition of the “Insured Persons” covered by the D&O policy needs to be checked to ensure that it covers all the senior managers now potentially affected.
- Those responsible for placing D&O cover must consider very carefully the possible financial demands on the policy and hence the limits of cover. D&O policies usually contain aggregate limits covering the total of all claims against all insured. However, the SM&CR is likely to result in a greater number of claims arising out of every regulatory breach, with pressure on those limits coming from a number of insured persons. Policyholders may need to consider negotiating increased or restructured limits, and/or prioritising or pre-apportioning limits between the various insureds to try to maximise cover for all.
- Care should also be taken to ensure that the rights of the insurer to avoid for non-disclosure or misrepresentation are excluded or limited as much as possible and, in particular, that any omission or breach does not affect an innocent “Insured”.
- Finally, if directors also benefit from indemnities from the firm, those placing the D&O cover should check that these indemnities dovetail with the insurance cover.

When making claims, the following key issues arise:

- The “Insured” giving notice under the policy must ensure that all time and formal requirements of the policy are strictly complied with. All layers of insurance should be notified, where there is a tower of insurance.
- The “Insured” should ensure at the outset that brokers and insurers have structures in place to deal with actual and potential conflicts between insureds.
- Individual “Insureds” should also ensure that they have sufficient input into/control over the claims process, which is often conducted by the firm.
- Corporate policyholders should ensure that any individual’s position under the policy is adequately protected.

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