

MARKET CONDITIONS AND THE RESULTS OF THE MARKET SURVEY

The Willis Index conducts a quarterly survey of the Lloyd's and London company market in which we invite responses from over 90% of D&O insurers and ask them to comment on premium rates and coverage terms for the preceding three months and over the next three months. The results are aggregated anonymously in this report.



A COMMERCIAL REALITY

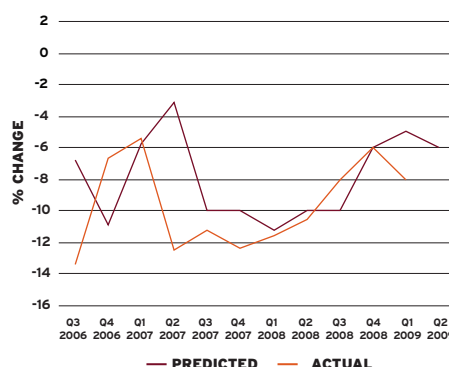
The commercial sector continues to benefit from a lower claims environment than the financial institutions sector, with rates continuing to soften, albeit at a much slower rate than last year. The anticipated hardening of rates for reinsurance treaties at the year end was less severe than expected, and combined with new entrants to the market, capacity for commercial risks continues to be strong.

In the medium term we expect to see some impact on the commercial sector from the overall deteriorating economic environment leading to increased claim activity, as well as portfolio convergence for insurers providing both commercial and financial institution coverage – however for now it remains a buyers' market where broad cover and higher limits are still available at an attractive price.

Over the last three months insurers reported an averaged premium reduction of 8% on renewal business which was greater than the 5% reduction predicted prior to the year-end reinsurance renewals, while the outlook for the next three months is for continued reductions in excess of 6%.

Insurers are still competing for clients whose risk profile fits their desired portfolio. In order to achieve a satisfactory renewal with flat or reduced premiums and broad cover tailored to the client's individual requirements, it is important to undergo a thorough risk profile analysis prior to renewal which highlights those positive aspects while pre-empting potential areas of concern (these could include highly-leveraged balance sheets, merger and acquisition activity and cash flow issues).

PREDICTED VS ACTUAL RATE CHANGE



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INDIVIDUAL LIABILITY

Steven Francis, Reynolds Porter Chamberlain

A recent consultation paper published by the Financial Services Authority¹ has interesting implications for individual liability under FSMA. The paper clarifies the role of Non-Executive Directors (NEDs). It also proposes to extend the FSA's approved persons regime to capture (i) individuals in a regulated company's parent undertaking or holding company who exercise significant influence on that regulated company and (ii) all proprietary traders (that is individuals who use the firm's capital to trade) rather than, as is presently the case, only senior traders.

This, as well as developments in other areas of law, will mean that the focus on director conduct will intensify considerably.

NON-EXECUTIVE DIRECTORS

The FSA authorises financial services firms to do business. It also has an approved persons regime which applies to individuals within firms. Those individuals are personally responsible for complying with certain FSA imposed rules, in particular the Statements of Principle and Code of Practice for Approved Persons. Two types of individual within firms are approved: those who deal with customers and their property and those who exercise a significant influence over a firm (SIF holders). The latter category includes all directors, whether non-executives or holders of full time executive positions.

The FSA's recent consultation paper says that it considers that NED duties should cover the following responsibilities:

- Assisting executive colleagues within the firm's governing body in setting and monitoring the firm's strategy;
- Providing an independent perspective to the overall running of the business, scrutinising the approach of executive management, the firm's performance and standards of conduct; and
- Carrying out other responsibilities as assigned by the board, for example as a member of a board committee, such as an audit or remuneration committee.

The FSA says: "Our expectations of non-executives and executives are different. In the past we have said that we will not discipline non-executives if they have acted in accordance with their roles and responsibilities when things go wrong. In the future, we will look at non-executives more closely if we believe that they should have intervened when executives are making sustained poor decisions."

CONSEQUENCES FOR DIRECTORS

The new proposals are further evidence of a hardening in attitude at the FSA toward director behaviour. Now, and for some time in the past, lawyers and investigators in the FSA's Enforcement Division have looked at their cases with a view to identifying failures by SIF holders so that enforcement proceedings can be brought against those individuals. Margaret Cole, the Director of Enforcement,

speaking at the FSA's Enforcement Law Conference in June 2008, could not have been more explicit: "Previously for SIF holders, we've tended to focus on cases of dishonesty or lack of integrity where prohibitions or withdrawal of approval is the most appropriate outcome. In the future, we will also consider the competence of SIF holders, and we won't shy away from pursuing cases against SIF holders who've breached our Principles and Code.... We've made a strategic decision to investigate more individuals. So even if that means that cases could well take longer and quick public outcomes are delayed we consider that to be a price worth paying to achieve credible deterrence."

SIF HOLDERS IN PARENT COMPANIES

Individuals in a regulated firm's parent company to whom the regulated firm has delegated authority for management decisions will currently be caught under the approved persons regime. As the FSA says though, the approach is uneven. Its proposed rule change will clearly capture individuals such as directors, non-executive directors or senior managers employed by a parent company or holding company whose decisions, opinions or actions are regularly taken into account by the governing body of the authorised firm.

PROPRIETARY TRADERS

Currently proprietary traders are caught by the approved persons regime if they are senior managers and either are the head of a trading desk or have trading limits that could expose the firm to significant risk. The FSA's proposed rule changes would effectively mean that all proprietary traders would require approval.

IMPLICATIONS

In the past D&O cases have tended to concern fraud and impropriety. We can expect a new class of D&O claim based on director's responsibilities for gross failures in corporate strategy. Directors in financial services firms might be particularly exposed.

Perhaps the biggest difficulty will be managing conflicts at board level. A common defence of a full time director might be that business plans were discussed with experienced NEDs who raised no concerns. NEDs might complain of the level and quality of management information provided to them before their views were sought. Newer NEDs might suggest that the greater burden of challenging executive directors falls on their more experienced NED colleagues.

The result might be what lawyers call 'cut-throat' defences: where directors take the view that their best strategy might be to blame each other. In such an environment it might be difficult for directors to agree on a common approach that actually best suits all of them; for example, defending the strategy adopted by the board and identifying other culpable parties such as advisors and regulators.

Much of the impact of a new and more aggressive approach will arise through both changes in law and changes in attitude. Regulatory statutes create criminal offences, one characteristic of which is that they are more likely to be committed by companies than by individuals; examples include health and safety, environmental protection, product safety, trading standards and breaches of trade sanctions rules. In all regulatory statutes there are provisions whereby, if an offence is committed by a body corporate, a director, manager, secretary or other similar officer of the body corporate can also be prosecuted if the offence was committed with his/her consent or connivance or is attributable to his/her neglect. A director who consents to or connives in an offence deserves all that is coming to him. Can the same really be said of a director who merely neglects his duty? Should the mere neglect of a duty result in the prosecution of a director, especially having regard to the fact that the majority of such offences are capable of being tried in a Crown Court in front of a jury? Regulatory and prosecuting authorities seem keener than ever to bring neglect-based criminal charges against directors.

The trend of creating new corporate and new D&O offences is set to continue. In the not too distant future we will see a new Bribery Act. While the existing law on bribery and corruption is outdated and cumbersome the Bribery Bill, although a definite improvement, contains many traps for the unwary and much of what might be regarded as fairly routine business entertainment and facilitation might be caught. A director who consents to or connives in an offence committed by the company (congratulations to the Law Commission for identifying that the neglectful director should not be caught) will also be guilty of an offence. The development of the law in this area should be closely monitored by insurers.

The consultation period on the proposals set out in the FSA's Consultation Paper 08/25 closes on March 31, 2009. With regard to the progress of the new bribery law no implementation date has been set but late 2009 to 2010 seems likely.

¹ Consultation Paper 08/25. The approved persons regime – significant influence function review. December 2008.



Steven Francis is a partner in the Commercial and Regulatory Group of the City Law firm Reynolds Porter Chamberlain. Until recently he was a Manager in the Financial Services Authority's Wholesale Enforcement Division where he dealt with insider dealing and market abuse investigations and alleged cases of systems and controls failures committed by large insurance businesses, banks and broking firms.

HERE TO HELP

The Willis M&A team remains very active even during the downturn in the M&A market. Those transactions that are progressing are increasingly finding that insurance due diligence reviews have taken on a greater level of importance and the use of insurance capacity as a means of providing representation/warranty and indemnity protection/security in deals is also significantly increasing. If you are involved in any M&A activity do not hesitate to contact the team to see how they could assist.





MEET THE TEAM

RUPERT HARMSWORTH

Rupert joined the team in March 2007 and is an account executive focusing on Directors & Officers Insurance, Pension Trustee and Employment Practices Liability. His primary focus is on advising clients in the UK and Europe on their exposures and insurance solutions, and negotiating cover on their behalf. Since joining he has developed a detailed understanding of the D&O marketplace and has quickly made himself a key member of the D&O team.

Rupert is a keen rugby fan although has himself retired from the sport due to repeated injury. When not limping between sports injury clinics he enjoys going to the cinema.

WILLIS FINANCIAL RISK SEMINAR: REPORT

D&O TRENDS AND WHAT TO EXPECT IN THE NEXT 18 MONTHS

The D&O market is entering a period of uncertainty.

David Purdy, Executive Director, Willis FINEX in London, told Norwegian risk managers at a panel debate on the D&O market in London.

Directors and Officers (D&O) Liability rates have fallen to low levels in recent years and coverage is at its broadest level ever. Claims have begun to rise against a backdrop of a financial crisis and recession.

Buyers of D&O insurance should go to the market earlier at their next renewal and be watchful for attempts by underwriters to reduce coverage.

Purdy noted buyers' concerns over financial security and ratings downgrades for a number of key players in the D&O market.

He warned that further insurer downgrades would lead to capacity problems, and directors should be concerned because all the ingredients for a claims 'perfect storm' have converged at the same time. Traditionally the biggest driver for D&O liability is corporate insolvency. The bankruptcy rate has rocketed since September 2008 and is widely predicted to continue to increase considerably. At the same time we have continued stock market volatility, increased regulatory activity and a number of class actions.

He suggested that buyers look carefully at which insurers are on their programmes, and to consider spreading the capacity across a greater number of carriers.

Rates for financial institutions have already risen, and prices for non-financial companies have flattened, he said. There is still significant capacity for directors and officers, but there is little doubt that it will shrink and that underwriters will become more selective.

According to Ed Smerdon, senior partner at law firm Reynolds Porter Chamberlain, who also spoke at the conference, D&O underwriters are not yet tightening coverage for non-financial companies, but more restrictive wordings are inevitable in a hardening market. While the market is unlikely to significantly pull back D&O coverage, Mr. Smerdon warned that underwriters were likely to 'tinker' with policy extensions and exclusions.

Mr. Purdy and Mr. Smerdon advised companies to pay more to keep coverage. "If I was a director I would be prepared to pay more to keep my coverage, because directors face (much higher risks) in the next 24 months", Mr. Smerdon said.

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