Clyde&Co

Financial and Professional Lines

End of year review 2021: Part 1 – Trends and developments

Contents

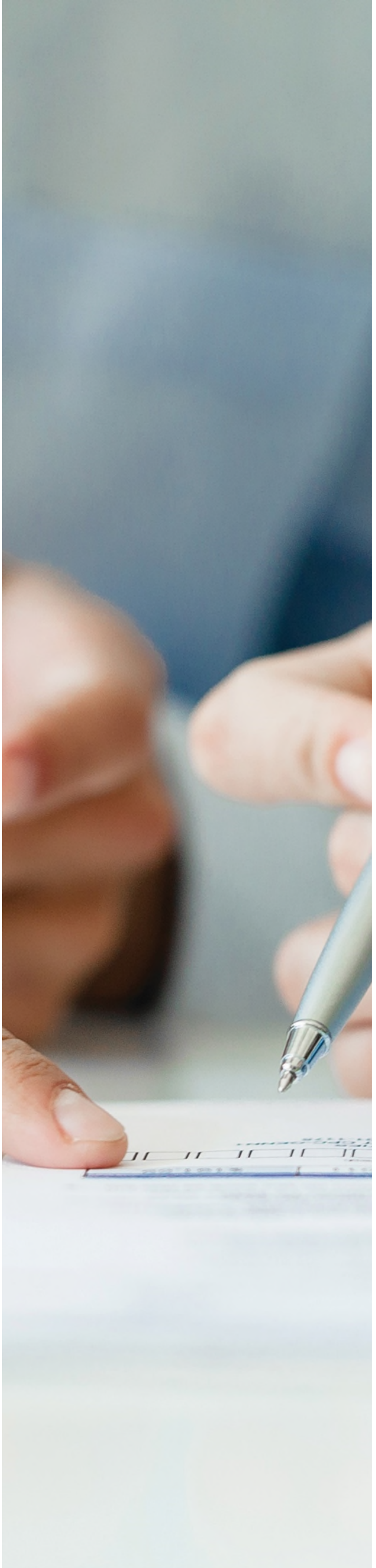
Introduction

2021 was perhaps not the year we had all hoped for after the year that was 2020. However, there was a return to some kind of normality for a time and this was certainly the case on the regulatory front for financial and professional firms.

In terms of claims, these remained steady in 2020 with previous years but a gradual increase in the number of claims in professional and financial lines is expected due to post-COVID financial uncertainty and difficult economic conditions. Whilst we are not yet starting to see the claims coming through in any great numbers, there is typically a time lag of around 18 months from the stressing event before claims start to emerge.

In this first part of a two part review, we look back at key developments over the past year impacting financial and professional lines. In the second part, which will be published shortly, we round up key case law from 2021 impacting the space.

Law as at 17 December 2021



Legal Profession

Regulatory / disciplinary matters

The focus of the Solicitors Regulation Authority (SRA) remains on many of the general themes, as follows

Heightened intervention/enforcement

The SRA continued the more interventionist approach it has taken in recent years, proactively identifying and pursuing cases (albeit sometimes with significant time delays). In our experience the SRA operated almost as usual during the various lockdowns and the Solicitors Disciplinary Tribunal (SDT) also continued to conduct hearings remotely. We expect issues around lack of supervision and breaches of client confidentiality, amongst others, to feature heavily in actions arising due to the pandemic.

Increased fines

On 19 November 2021, the SRA launched a consultation on its approach to financial sanctions where it proposes to increase the maximum fine it can impose from £2,000 to £25,000 and, in relation to serious cases, up to 5% of the firm's annual turnover. In addition, it is proposing the introduction of measures which would take account of income when setting fines for individuals where similar offences are committed and a series of fixed penalties of up to £1,500 in order for lesser breaches to be dealt with quickly. The proposals aim to resolve cases more quickly and free up the SDT to focus on serious cases of misconduct. The consultation runs until 11 February 2022.

Sexual misconduct

Cases concerning sexual misconduct and imbalances of power continue to be brought. At the end of 2020,the Divisional Court overturned the SDT's finding of professional misconduct against a former partner at a large law firm, relating to his sexual conduct towards a junior female lawyer, finding that he had not breached his professional obligations to act with integrity (SRA Principle 2) or to behave in a way that maintained the public's trust in solicitors (SRA Principle 6). The fine was quashed and the associated costs order set aside. The implications of the decision beyond the legal profession are considered in this briefing. The case raised questions about the extent to which the regulator can/should oversee solicitors' personal lives - but in practice we expect to see continued scrutiny of personal conduct, supported by various aspects of the new Standards and Regulations, introduced in November 2019, and supporting documentation, including the SRA's Enforcement Strategy and Guidance Notes issued on matters such as the use of social media.

Non-disclosure Agreements (NDAs)

As a connected point, the SRA, concerned with the use of NDAs for sexual misconduct issues, in November 2020 updated its Warning Notice on their use. In particular, the SRA is concerned to ensure that solicitors involved in their negotiation/agreement do not take unfair advantage of the other party nor seek to prevent them from making appropriate reports to the SRA or the police. However, a high profile SDT prosecution of a City partner who documented an NDA for Miramax and Harvey Weinstein with one of their former employees was permanently stayed in January 2021 on medical grounds.

Equality, Diversity and Inclusion (EDI)

We flagged last year the emerging prominence of diversity and discrimination issues and the new SRA Principle 7, requiring solicitors to act in a way that encourages equality, diversity and inclusion ("EDI"). Together with colleagues from our employment team we explored these issues in a webinar in May 2021 which can be reviewed here.

Dishonesty, mental health and toxic firm culture

These issues are under the spotlight following a number of cases in recent years involving junior solicitors acting rashly or lying in order to cover up an earlier mistake - often in circumstances where they were overworked, under great pressure from toxic working environments and, in some cases, suffering from mental health issues. The junior solicitor has typically been struck off for dishonesty while the firm itself has escaped censure, an outcome which has attracted criticism.

There are some indications that the SRA may be starting to modify its approach in such circumstances. Firstly, there have been a few cases in the last 12 months or so in which the junior solicitor has not been struck off – and in March 2021 it was reported that the SDT would re-hear the high-profile case of a newly qualified solicitor who was struck off after she left a briefcase on a train and initially lied about it, but this time with new medical evidence about the mental health condition she had raised at the original hearing and with legal representation, which she could not afford originally. Secondly, the SRA Principle relating to EDI (as above) and the stated intent in the SRA Enforcement Strategy to take action against firms where the events demonstrate a failure which relates to the firm's culture, systems and supervision arrangements suggest we will increasingly see the firms themselves held to account.

Financial misconduct and money laundering

These remain a source of many breaches and a key area of regulatory concern, as underscored by the SRA's Business Plan 2021-2022 published on 25 October 2021. In February 2021, all legal services supervisors in the UK collectively published detailed Anti-Money Laundering Guidance for the Legal Sector (2021) and the SRA published a Sectoral Risk Assessment looking at the specific risks and challenges within legal services in combatting money laundering.

Claim Trends

Impact of COVID

While we have been instructed on some Covid-related claims against lawyers, we are yet to see these come through in substantial numbers. This accords with the ongoing nature of the COVID pandemic (and responsive measures) and our expectation that there would then be a typical time-lag of approximately 18 months. In due course we expect to see 3 broad categories of claim against lawyers: (i) familiar recessionary claims; (ii) claims arising out of work done previously which the circumstances of the pandemic/lockdown put under particular scrutiny; (ii) claims arising out of work done during the pandemic and errors arising from the homeworking environment.

While the pandemic is an unprecedented event in our lifetimes, the risk of professional liability claims in the wake of economic downturns is more familiar. But the parallels only go so far. For example, we went into this crisis from a better economic base and there are now tougher regulatory regimes and expectations. On the other hand, there is an ever-stronger clamour to find someone to blame (preferably insurance backed professional advisers) and funding for claims is more available (see below). There are also many other variables at play including the economic recovery in the UK, itself dependent on factors including ongoing vaccine success, new Covid-19 variants, any further lockdowns, the withdrawal of Covid support measures and separate significant issues like Brexit and the divergent fortunes of the commercial and domestic property markets.

Claims inflation

Over the past few years we have seen -and we expect to continue to see - huge claim value inflation. We frequently see claims running to tens of millions and in some cases to hundreds of millions of pounds.

Increase in costs of defending claims

We also have seen and expect to continue to see an increase in the cost of defending claims due, amongst other things, to their complexity, the multi-jurisdictional nature of many underlying disputes or transactions, and the costs of disclosure.

Emerging liabilities

Malware/ransomware attacks have increased in the remote-working era against both law firms and barristers chambers. While these give rise to first party issues and costs, they may also lead to regulatory claims and substantial third party claims from clients/others.

Increased availability and sophistication of litigation funding

An increase in the number of litigation funders entering the UK market or making funds available from offshore are facilitating claims, as are the increasing range and sophistication of funding options available. And claims against professionals are often considered attractive to funders as the claims arise out of matters that are usually well-documented and the professional defendants are backed by insurance. However, the costs exposures for funders can be considerable – see the COSTS section below for discussion of some recent decisions made against claims funders.

Accountants and Auditors

Regulatory and claims landscape

Audit reform

The Department for Business, Energy and Industrial Strategy (BEIS) published its long-awaited White Paper 'Restoring trust in audit and corporate governance' on 18 March 2021 which, if translated into law, will introduce significant changes for auditors, directors and stakeholders, as well as empowering an altogether more muscular regulator.

The white paper contains a number of proposals, including:

- Expanding the definition of Public Interest Entities (PIEs)
- Establishing the Audit, Reporting and Governance Authority ("ARGA") as the new regulator with enhanced powers
- New corporate reporting requirements
- Improved audit quality through a variety of proposals
- Operational separation
- Managed shared audit
- Directors' accountability (discussed further below in the 'Financial Institutions and D&O' section)

For more information see our series of briefings on the proposals:

- White paper overview
- White Paper Bulletin 1 – audit purpose, scope, liability and engagement with shareholders
- White Paper Bulletin 2 – privilege reform in regulatory investigations
- White Paper Bulletin 3 - new corporate reporting – brave new world?
- White Paper Bulletin 4 - Competition, choice and resilience in the audit market
- White Paper Bulletin 5 - Redressing the balance between auditors and directors
- White Paper Bulletin 6 - a strengthened regulator
- White Paper Bulletin 7 – supervision of audit quality and additional changes in the regulator's responsibilities

FRC Annual Enforcement Review 2021

On 29 July 2021 the FRC released its 2021 Annual Enforcement Review (the "Review") summarising the FRC's enforcement work over the past year. Key themes were the failure of auditors to exercise professional scepticism (ISA 200), issues in connection with auditors' preparation of audit documentation (ISA 230) and companies' financial reporting. The report details the growth of the Constructive Engagement process as an alternative to full enforcement action, with 48 cases having been resolved through the process over the past year, an increase of 45% on the previous year.

Other aspects of the Review seem quite transparently to mesh with the wider reform agenda ushered in by the publication of the BEIS white paper. One obvious example is the emphasis on issues around preparing and approving companies' financial reporting, which clearly has one eye on the FRC's Future of Corporate Reporting Project, and the sustained political and parliamentary focus on the role of audit and the need for audit reform more generally.

Likewise, the growth in the FRC's headcount is part of its preparations to morph into ARGA (at some point). We expect to continue seeing the upward trend in more investigations being opened as the Enforcement Division expands.

For more information see our full briefing here.

Audit Enforcement Procedure

On 22 July 2021, the FRC launched its long-awaited consultation on reform to the Audit Enforcement Procedure (AEP). The AEP was introduced in June 2016 and is the enforcement and disciplinary regime that applies to investigations commenced by the FRC after that date. Whilst numerous investigations have been conducted under the AEP, as yet none has gone to a contested Tribunal hearing. In large part this may be a reflection of the change in the burden of proof from the test of 'misconduct' under the Accountancy Scheme ("the Scheme") to the comparatively low test of a 'breach of a Relevant Requirement' under the AEP.

Following its consultation, which closed on 7 October 2021, the FRC is proposing a number of amendments to the AEP. It is unclear when the new AEP rules may be introduced. It should be noted that the changes proposed deal with the existing regulatory framework for auditors of PIE entities and do not address the regulatory and investigations framework envisaged in the Government's recent White Paper on corporate reform (e.g. the regulatory framework that will apply to investigations involving non-accountant company directors alongside auditors).

In this bulletin we summarise some of the key changes being proposed.

Fraud

In May 2021, the FRC issued a revised auditing standard for the auditor's responsibilities relating to fraud, which enhances the requirements on auditors whilst also placing an onus on company boards to demonstrate how they are tackling potential fraud. The revised standard is to apply for audits beginning on or after 15 December 2021.

The FRC's revised standard is here and it has also published a feedback statement which explains the changes.

FRC supervisory focus for corporate reporting and audit

On 3 December 2021 the FRC announced that it would be conducting six thematic reviews to identify scope for improvement, as well as examples of better practice, in areas of key stakeholder interest. These reviews include a review of TCFD disclosures provided by premium listed companies in response to the new Listing Rule, and of the extent to which the financial statements reflect the impact of climate change. In addition, the FRC intends to carry out audit quality inspections with particular focus on auditors' work in relation to: climate-related risks, fraud risks, cash and cash flow statements, provisions and contingent liabilities, impairment of assets, revenue, and group audits.

For more information, see here.

Construction PI

Construction PI

Regulatory

The regulation of construction professionals has been on the radar this past year.

In August, the Ministry of Housing, Communities and Local Government (now called the Department for Levelling Up, Housing and Communities) published a call for evidence on the regulation of architects in the UK, stemming from changes arising in the regulatory regime of architects following Brexit, future trade agreements and building safety reform.

The call for evidence closed on 8 November 2021, with next steps likely to take place in the summer of 2022.

In October 2021, the Royal Institute of Chartered Surveyors (RICS) launched new Rules of Conduct to underpin the confidence of clients, markets and the public in the profession. Amongst other things, the new code sets out refreshed requirements for professionals in relation to maintaining their skills and expertise, including new expectations in respect of advice on sustainability issues. The new Rules of Conduct will come into effect from 2 February 2022.

Claims

In terms of claims, there is continued uncertainty about how cladding system and fire safety losses will impact the market, with construction professionals such as architects, engineers and building control/fire experts in the line of fire as Employer and contractor losses are crystallising and the wave of recovery actions starts to escalate. Policy exclusions/restrictions for fire safety are now ubiquitous and yet new problems continue to emerge.

The unpopular EWS1 form seems set to be replaced by PAS9980, a new code of practice for fire risk appraisal, the full effect of which on existing claims/need for remedial work will take time to work out.

There is also justifiable nervousness in the market around the potential for the government retrospectively to extend limitation periods under the Defective Premises Act 1972 to 15 years, to extend the DPA to include building work to existing dwellings and the belated bringing into force of s38 of the Building Act 1984, which will create a new statutory right of action in relation to breach of a duty imposed by the building regulations causing damage.

Financial Institutions and D&O

FCA Enforcement

FCA enforcement activity remains a substantial exposure for companies and D&Os. From the FCA's Enforcement Data 2020/21 to the year ending 31 March 2021, the FCA achieved 147 outcomes using its powers of enforcement and issued fines of £189.8m. Both figures are down on figures for the previous two years.

The drop is likely to be attributed to the pandemic disruption, which impacted regulators' ability to conduct witness and suspect interviews and which required regulators to focus attention on steering regulated entities through the crisis as well as on the FCA test case. However, there has been an increase in activity since Autumn 2020 and we can certainly expect activity to rebound. .

The top five areas of enforcement remain similar to previous years: unauthorised business, retail conduct, insider dealing, financial crime and advice in relation to pensions. This is set alongside overarching themes such as seeking to hold individuals to account, improving corporate culture and tackling market abuse. Decision notices in relation to non-financial misconduct are also on the rise. For more information on this, see our article on a recent decision.

When the pandemic hit, both the FCA and the PRA set out their expectations, further to existing rules, that firms have contingency plans in place that are effective and proportionate for their business as a result of the coronavirus outbreak. Regulators are "actively reviewing" these plans and where weaknesses are identified, they will expect firms to act and/or face regulatory investigations. This is especially so as systems and controls failings have increasingly been cited in penalty notices in recent years. New final rules were published on 29 March 2021, with firms expected to comply with the new requirements by 31 March 2022.

Senior managers may face investigations and sanctions under the Senior Managers & Certification Regime (SMCR) for a range of failings, though it is worth noting that so far enforcement numbers under the SMCR remain low. However, we may see action taken against companies and their D&Os for a range of other COVID-related failures, for example, treating consumers and businesses unfairly, corporate governance failings or inadequate or misleading disclosures etc.

There are also many moves on regulation, which may lead to an increased exposure to regulatory claims, including: reviews into unauthorised business, the limits of the regulatory perimeter, the new Financial Services Act, liquidity mismatch, regulatory approach to crypto assets and stable coins and the assessment of suitability of investments. In addition, on 14 May 2021, the FCA published a consultation paper (CP21/13) on a new consumer duty, which will set a higher level of consumer protection in retail financial markets for firms to adhere to. It is likely to require a significant shift in corporate culture and behaviour and the consultation notes that regulatory action is expected following failures in relation to the new duty. The FCA published a second consultation (CP21/36) on 7 December 2021 which runs until 15 February 2022. The FCA intends to publish a policy statement with final rules by 31 July 2022.

Corporate and D&O criminal liability

The Law Commission published a discussion paper on 9 June 2021 which sought views on the law surrounding corporate criminal liability and how it can be improved so that not only are criminal actions sanctioned appropriately but corporations and their D&Os foster a culture of corporate responsibility.

In particular, it questions whether more 'failure to prevent' offences for corporates (akin to those already present in the Bribery Act 2010 (which in 2021 marked its tenth anniversary) and the Criminal Finances Act 2017) should be introduced and whether the 'identification principle' should be reformed. This is where, in order for the company to be held liable, a prosecutor must prove that the individuals involved in the crime represent the "directing mind and will" of that company i.e. the individuals' actions are to be considered those of the company. This is very difficult to establish and has led to a low number of convictions.

The reforms could lead an increased risk of prosecution for corporates and D&Os. The Commission is now analysing the responses to the consultation, which will inform the development of the options paper. It is aiming to publish this in early 2022.

Another consideration is deferred prosecution agreements. Corporates may enter into DPAs in relation to these offences (if agreed by the SFO and approved by the Court). Twelve DPAs have been agreed to date. The increased use of deferred prosecution agreements can expose D&O wrongdoers to subsequent investigations and prosecutions, with companies cooperating with the SFO in pursuit of a deal. This clearly exposes directors to subsequent prosecution. However, to date, no prosecutions have been successful (see this article). The reforms will seek to address this.

The conversation is moving, and we can only expect there to be more scrutiny and investigations into companies that fail to prevent crime within their organisations, presenting a greater risk to FIs and their D&Os.

For more information, see our article here.

Also on the criminal front, the new civil and criminal powers afforded to the Pension's Regulator have now come into force. The regulator has been taking a more aggressive stance of late and an increase in enforcement action against D&Os is expected.

Audit reform – impact on directors

If translated into law, the audit reforms underway have the potential to markedly change the liability landscape for directors and officers of public interest entities (PIEs).

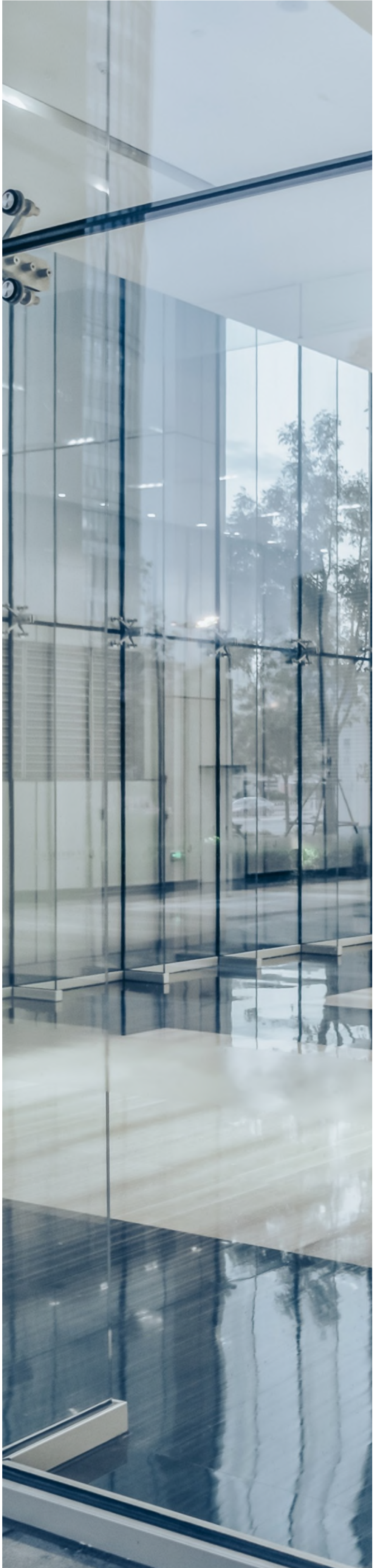
As mentioned above, the FRC is to be replaced by a new regulator, known as the Audit, Reporting and Governance Authority (ARGA), which the Government proposes will be given the necessary investigation and enforcement powers to hold all directors of PIEs to account for wrongdoing in cases where there have been breaches of directors' duties regarding corporate reporting and audit. Existing powers held by other enforcement agencies would not be affected and responsibility for bringing directors disqualification proceedings would remain with the Insolvency Service.

A related proposal is that ARGA should be empowered to impose more detailed requirements, and separate behavioural standards (such as acting with honesty and integrity), as to how PIE directors should comply with their existing statutory duties relating to corporate reporting and the audit of PIEs, and make clear that directors will be liable to civil enforcement action for breach of those requirements.

Further, it is proposed that there be new director reporting and attestation requirements covering internal controls, dividend and capital maintenance decisions, and resilience planning, in keeping with the recommendations made in recent reviews and consultations.

It is expected that ARGA would be created in April 2023. Directors can expect to face further scrutiny and increased enforcement action once the changes are in force.

For more information see our briefing here.



Climate change-related financial reporting

The audit reforms and strengthening corporate governance requirements sit alongside developments in climate-related financial reporting. Increased scrutiny over managing climate-related financial risks will require boards to regularly consider the effect that climate change risks may have on their business, with the potential for failings to result in claims impacting across D&O and E&O.

There have been significant developments in the UK around climate change reporting in the last few years. The UK government was an early supporter of TCFD and it was recently announced that the UK will become the first G20 country to enshrine in law mandatory TCFD-aligned requirements for Britain's largest companies and financial institutions to report on climate-related risks and opportunities. From 6 April 2022, over 1,300 of the largest UK-registered companies and financial institutions will have to disclose climate-related financial information on a mandatory basis – in line with recommendations from the TCFD. This will include many of the UK's largest traded companies, banks and insurers, as well as private companies with over 500 employees and £500 million in turnover.

Non-mandatory guidance to support in-scope companies in their disclosure is scheduled to be published in early 2022, following parliamentary scrutiny of the regulations.

This follows other developments over the past year, including the introduction of a new rule applying to accounting periods beginning on or after 1 January 2021 which requires UK incorporated and overseas commercial companies with a premium listing to include a statement in their annual financial report which sets out whether their disclosures are consistent with the TCFD recommendations, or to explain if they have not done so. The UK government launched a consultation 24 March 2021 on the extension of this rule to a wider group of entities and, later, on 22 June 2021, the FCA published a consultation paper on proposals to extend the climate-related disclosure requirements in LR 9.8.6R(8) for premium-listed commercial companies to certain issuers of standard listed equity shares.

On 17 December 2021, FCA published two Policy Statements (PS21/23 and PS21/24) confirming final rules and guidance to promote better climate-related financial disclosures.

There is the potential for regulatory actions against companies and D&Os for reporting failures and there may also be exposures for auditors, pension trustees and asset managers. Companies also need to be alive to the risks of “Greenwashing“, a term which refers to companies overstating positive environmental impacts, as well as understating risks. The FCA and CMA are looking closely at this issue.

Special Purpose Acquisition Companies (SPACs)

SPACs are newly formed companies which are floated on a stock exchange in order to raise public capital with the promise that the funds will be used to merge with or acquire an existing (typically private) company, ordinarily within two years. Investors do not know who the target will ultimately be or the likelihood therefore of their success. After a suitable target company has been identified, the SPAC merges with the target company through a reverse merger, a process sometimes known as 'de-SPAC'.

Although in existence for some time, there has been a dramatic increase in the use of SPACs in the US in recent times and we are starting to see SPACs develop here in the UK.

Whilst regulators are getting to grip with the issues around SPACS, one clear trend has emerged in the US – a rise in SPAC litigation and the resulting D&O exposure which we can expect to follow in the UK too.

For more information on SPACs, please see this article on the exposures SPACs raise for D&Os and their insurers and this article on the UK's new listing rules in relation to these investments and their potential impact on deal activity and claims trends.

Securities class actions

The market is seeing an increase in high value, high profile claims being instigated or threatened by large groups of claimants against both corporate defendants and D&Os and this looks set to continue, particularly as “conflict free” boutique litigation firms, akin to those of the US Plaintiff bar, establish themselves in the UK with a focus on corporate bodies and individuals.

Directors have exposure here. In the Lloyds Shareholder Action, brought under common law, the claim was pursued against the former Board as well as the bank itself. Whilst the claim failed against the directors, it shows the types of allegations that may be brought and the exposures directors may face. Further there may be exposures under s. 90 and s. 90A FSMA claims. Potential defendants to section 90 claims are those persons responsible for prospectuses, who include the issuer (i.e. the company) and each director of the issuer at the time the listing particulars or prospectus was submitted to the UKLA. Under s.90A the issuer will be liable in respect of any untrue or misleading statement only if "*a person discharging managerial responsibilities within the issuer knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading.*"

Similarly, the issuer will only be liable in respect of the omission of any matter required to be included in published information if "*a person discharging managerial responsibilities within the issuer knew the omission to be a dishonest concealment of a material fact.*"

This, in effect, means the directors. While a claim under section 90A can only be brought against the issuer, so not against any directors, as is the case with section 90, it may be that directors will have a back to back liability to the issuer under section 463 of the Companies Act 2006 or otherwise for breach of fiduciary duty or negligence.

A case currently progressing through the courts is *Allianz Global Investors GmbH & Ors. v RSA Insurance Limited*. A claimant group of over 70 institutional investors brought a s.90A claim against RSA, making allegations as to RSA Insurance’s published statements, or omissions to disclose matters relating to financial conduct and corporate governance. These specifically relate to RSA Insurance’s involvement in inappropriate accounting practices and the alleged deliberate manipulation of insurance claim reserves. The claimants’ case is that:

- from 2009 to 2013, RSA Insurance: published statements that were untrue or misleading in relation to financial misconduct and inadequate corporate governance within RSA Ireland; and omitted to disclose such matters and/or (c) delayed publishing information in respect of them; and
- various senior executives within the RSA Insurance knew or were reckless as to the falsity of the published statements and/or knew the omissions to be dishonest concealment of a material fact and/or acted dishonestly in delaying the publication of relevant information.

As such, the directors are being put squarely in the firing line and we await the outcome of this case with interest.

440

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4,000

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50+

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