Association of Financial Mutuals

Duties of Directors of Mutual and Not-for-Profit Insurers

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Overview

A mutual insurer or not-for-profit insurer will most commonly be a company limited by guarantee, a company limited by shares (where the shares are held on trust), a registered (ie unincorporated) friendly society or an incorporated friendly society. Regardless of the legal form, the ultimate decision making body within the firm will be comprised of members, who will usually be policyholders, but the general direction and management of the firm will be delegated to a board of directors. In a friendly society, whether registered or incorporated, the technical term for the board is a 'committee of management' but many friendly societies refer to their committees of management as boards and to individual committee members as 'directors' and we have adopted this terminology throughout this guide regardless of whether we are referring to a company or a friendly society.

The duties of directors are a combination of a range of elements, with a heavy amount of overlap between them:

- General law, which derives from the fiduciary duties imposed on trustees under case law dating back to the 18th century. For mutual and not for profit insurers that are constituted as companies the case law has been replaced by (largely equivalent) statutory duties in the Companies Act 2006, but for friendly societies the old case law continues to apply; and
- Sector specific legislation, including the Friendly Societies Act 1992, which sets out individual duties and the collective responsibilities of directors of friendly societies; and
- Regulatory rules within PRA's and FCA's Senior Managers' & Certification Regime, as extended in December 2018; and
- Codified expectations via the AFM's Corporate Governance Code.

Necessarily, this guide provides a general overview of the law on the duties and responsibilities of directors. This is a complex area of law and a guide of this length cannot set out comprehensively all the nuances or deal with every situation that may arise. AFM and M&G Advisory Services Limited have taken every care when compiling the guide but cannot accept any responsibility for reliance upon it. AFM member firms and their directors should take specific legal advice on any issues that arise relating to directors' duties.

General Law

Directors have a very similar relationship with the members of a firm as trustees have with the beneficiaries of a trust. Since the mid-18th century, when the advantages of doing business through a company began to be widely recognised, the courts of equity began to apply the trust law concept of 'fiduciary duties' to company directors. After Parliament made the process of incorporating a company much easier with the Joint Stock Companies Act of 1844 many more companies were formed, resulting in a burgeoning of litigation from the mid-19th century onwards in which companies challenged the behaviour of directors. Thus, the law on directors' fiduciary duties developed from judgements on a series of individual cases, often expressed in archaic language and from which it is not always easy to draw general principles.

Parliament codified this body of case law under the Companies Act of 2006 and replaced the fiduciary duties with a set of statutory duties. These of course apply only to directors of companies governed by the Companies Acts and not to directors of friendly societies, which remain subject to the old case law on fiduciary duties. The Companies Act statutory duties are binding on the directors of companies and, notwithstanding that friendly societies are not governed by the Act, are likely to act as a good rule of thumb for directors of friendly societies too (although in areas of doubt, friendly societies and their directors should always take separate legal advice). The statutory duties are in Chapters 2 and 3 of Part 10 of the Act and may be summarised as follows (using the section numbers from the Companies Act 2006, https://www.legislation.gov.uk/ukpga/2006/46/part/10):

s171	to act within the powers conferred by the firm's constitution and for the purposes for which those powers were conferred
s172	to promote the success of the firm; this is a wide-ranging duty that includes taking into account the interests of employees, customers, suppliers, the wider community and the environment
s173	to exercise independent judgment
s174	to exercise reasonable care, skill and diligence; the Act, like the case law it replaced, makes clear that the standard to be applied is the knowledge, skill and experience that may reasonably expected of a person carrying out the director's role and the actual knowledge skill and experience that the director in fact has. Thus, in the context of a mutual insurer, some degree of financial knowledge and skill would be required of all directors but a higher standard would be applied to any director who is also, for example, an accountant or actuary.
s175	to avoid conflicts of interest (although conflicts can be sanctioned in certain circumstances)
s176	not to accept benefits from third parties if the benefits relate to the director's status or actions as a director

There is a further statutory duty under s177 to declare any proposed transaction or arrangement with the firm in which the director has a direct or indirect interest and under s182 to declare any existing transaction or arrangement in which the director becomes directly or indirectly interested. In this instance there is a similar statutory requirement on directors of

friendly societies under s63 of the Building Societies Act 1986 (somewhat confusingly schedule 11 to the Friendly Societies Act imports the provisions of sections 62-70 of the Building Societies Act 1986 which relate to dealings between a building society and its directors with some minor modifications and applies them to friendly societies).

Directors should be aware that the constitution of their firm may also impose additional restrictions on the declaration of directors' interests and the manner in which a director may participate in a decision on a matter in which he or she does have an interest.

Alongside the fiduciary duties Parliament had, since at least the Companies Act of 1948, imposed restrictions on financial dealings, such as loans by a company to its directors. These restrictions now are found in Part 4 of Chapter 10 of the Companies Act. In this area the Friendly Societies Act of 1992 also makes statutory provision for friendly societies (both registered and incorporated) by importing the relevant sections of the Building Societies Act as noted above. The restrictions imposed by the Building Societies Act are broadly similar to those under the Companies Act restrictions but do contain some differences.

These restrictions may be summarised as follows (again using the section numbering from the Companies Act but with the Building Societies Act provisions noted in italics):

s188	to obtain members' approval for any director's service contract lasting more than two years; *no equivalent under the Building Societies Act, although this would also constitute good practice for a friendly society;*
s190	to obtain members' approval for substantial property transactions between the firm and a director or a person connected with a director; *s64 Building Societies Act imposes a similar requirement on friendly societies, although the definition of 'substantial' is slightly different;*
s197	to obtain members' approval before making loans to a director or to a person connected with a director; loans are permitted without member approval for certain expenses related to the performance of a director's function and for loans of less than £10,000; *s65 Building Societies Act imposes a similar requirement on friendly societies, again with some differences.*

Regarding non-executive directors (NEDs), the Institute of Directors states that they should bring the following to a board:

- independence (ie removed from the day-to-day running of the business),
- impartiality,
- wide experience,
- special knowledge, and
- personal qualities.

It goes on to identify their key responsibilities as including strategic direction, outside communication, and risk: https://www.iod.com/services/information-and-advice/resources-and-factsheets/details/What-is-the-role-of-the-NonExecutive-Director.

While the general law does not distinguish between executive directors and NEDs in respect of the framework of duties, the degree of care, skill and diligence that it is reasonable to expect of a NED under s174 and under the corresponding common law fiduciary duty may be different from that expected of an executive director.

But some litigation, notably that concerning Equitable Life in 2003, emphasised that the above points do not give NEDs a free pass – the judge held that it was "plainly arguable ... that a company may reasonably look to non-executive directors for independence of judgement and supervision of the executive management". In addition, the regulators are taking an increasingly strong stance on their expectations; for example, through their work on *strengthening accountability* (see below). But regulations cannot, and must not, seek to turn NEDs into executives.

Directors need also be aware of any modifications to the duties discussed above that may be contained in the constitutional documents (the articles of association of a company, the rules of a registered friendly society and the memorandum and rules of an incorporated friendly society) of their particular firm.

Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties.

Sector specific legislation

Any body corporate may only engage in activities that are permitted under the governing legislation applicable to it and under its constitutional documents. These are known as the 'objects' and 'powers' of a company and the 'purposes' and 'powers' of an incorporated friendly society. Registered friendly societies are not bodies corporate but must nevertheless adopt at least one of the principal purposes permitted for incorporated societies.

The Companies Act 2006 allows companies to adopt unrestricted objects but the articles of association of most insurance companies, including mutuals, will specify the objects of the company and directors must ensure that the company only conduct activities that are in pursuit of those objects. Under the Friendly Societies Act 1992, by contrast, the activities that incorporated friendly societies can include in their purposes are very narrowly restricted by Section 5 which provides that an incorporated friendly society may be established under the 1992 Act only if:

> (a) its purposes are to include the carrying on of one or more activities falling within Head A, B, C or D of Schedule 2 to this Act (which set out certain classes of life and health insurance and some discretionary products);
> (b) any such activity
> i. is to be carried on by the society with a view to the provision, for its members and such persons connected with its members as may be prescribed in its rules, of insurance or other benefits; and
> ii. is to be funded by voluntary subscriptions from members of the society, with or without donations; and
> (c) any other purposes which it is to have are within the permitted capacity of incorporated friendly societies under this Act.

The "other purposes" referred to in section 5(c) are:

- Social or benevolent activities (permitted under section 10)
- Group insurance business (permitted under section 11)
- Reinsurance of risks held by other friendly societies (permitted under section 12)
- Control or joint control of bodies corporate, ie holding subsidiary companies or joint-ventures (permitted under section13)
- Certain miscellaneous activities permitted under schedule 5.

Directors must be satisfied that all the activities of their firm are being carried out in pursuit of one or more of its objects (if a company) or purposes (if an incorporated friendly society). They must also ensure that the means by which they are carried out are within the powers of the firm. Like the objects and purposes, the powers need to be permitted under the governing legislation and adopted under the firm's constitution. The powers available to companies under modern company law are unrestricted and even for friendly societies they are very wide, permitting a society to adopt the power to do anything that is "incidental or conducive" to its purposes. Nevertheless directors must only exercise their firm's powers strictly in compliance with the articles of association or memorandum and rules. These may impose various restrictions, eg in relation to the notice periods for meetings and the manner in which meetings are conducted.

Regulatory

General

There is a very wide range of principles, rules and guidance to be found in the FCA Handbook, the PRA Rulebook and other PRA documents such as PRA supervisory statements. It may not be possible to be familiar with the details of all of the regulatory provisions, but it is important to be aware of the ones that are relevant to your role in the firm.

There are increasingly high regulatory expectations on chief executives, Boards (including non-executive directors), and relevant professionals to take steps to ensure that there are effective processes to identify, manage, monitor, review and report relevant risks, and that firms have associated strategies.

Since 7 March 2016, FCA's COCON sourcebook contains guidance on the role and responsibilities of non-executive directors at authorised firms, including the role of a chairman, the general role of a NED, the role of a NED as chair of a board committee, and other related matters. The sourcebook also reflects rules relating to the Senior Managers & Certification Regime.

The FCA summarises the role of a NED performing the general NED role as being to provide effective oversight and challenge, and help develop proposals on strategy. To deliver this, their responsibilities include attending and contributing to board and committee meetings and discussions; taking part in collective board and committee decisions, including voting and providing input and challenge; and ensuring they are sufficiently and appropriately informed of the relevant matters prior to taking part in board or committee discussions and decisions.

The FCA identifies other key roles for NEDs as including –

- scrutinising the performance of management in meeting agreed goals and objectives
- monitoring the reporting of performance
- satisfying themselves on the integrity of financial information
- satisfying themselves that financial controls and systems of risk management are robust and defensible
- scrutinising the design and implementation of the remuneration policy
- providing objective views on resources, appointments and standards of conduct, and
- being involved in succession planning

https://www.handbook.fca.org.uk/handbook/COCON/1/Annex1.html?timeline=True

Strengthening Accountability: conduct rules

Since 2013, the boards and senior managers of insurers have become subject to progressively tighter regulation, as evidenced by PRA's approach to strengthening accountability in banking and insurance. On 10 December 2018 these rules were extended to include the certification requirements for banking, and have the effect of extending conduct rules to all NEDs. For more on the effects of the extension of SM&CR to insurers, see: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-insurance-ss.

The conduct rules for directors are set out across the rulebooks of both regulators. Most of the conduct rules are pretty straightforward in principle, but they are not necessarily simple to apply in practice.

To a large degree, the conduct rules for senior managers and individuals more generally, mirror the regulators' expectations of the firms that they work for. Therefore, firms and individuals working within them have a unity of interest in getting things right. For example, the FCA's Principles for Business and the PRA's Fundamental Rules both require a firm to conduct its business with integrity and with due skill, care and diligence; at all times to maintain adequate financial resources; to organise and control its affairs responsibly and effectively with adequate risk management systems; and to deal with its regulators in an open and cooperative way, with appropriate disclosure etc.

Each regulator also has certain requirements relevant to their respective regulatory roles eg the FCA explicitly requires firms to pay due regard to the interests of customers and treat them fairly, and the PRA expects firms to act in a prudent manner.

Each regulator will assess compliance or a breach by having regard to the context in which a course of conduct was undertaken, including:

- the precise circumstances of the individual case
- the characteristics of the particular function performed by the individual in question, and
- the behaviour expected in that function.

A person will only be in breach of any of the conduct rules if they are personally culpable. Personal culpability arises where a person's conduct was either deliberate or the standard of conduct was below what would be reasonable in all the circumstances (ie careless).

The PRA has set out its expectations of board responsibilities in SS5/16 (at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss516update.pdf?la=en&hash=9FA09D82A6431745BBA95B3943C9AD13A5FB40A7). As part of its consultation on a previous version of its supervisory statement it had identified certain hypothetical examples where sanctions might apply to executives and NEDs. These are likely still to be relevant and can be read at the end of Appendix 2 to the consultation at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2015/cp715.

The AFM corporate governance code

The AFM Corporate Governance Code, took effect from 1 January 2019, which sets out a series of principles of good corporate governance that our members apply within their business. The Code draws on expectations of directors from a range of sources, including the relevant legislation, regulatory rules and internationally recognised standards.

The AFM Corporate Governance Code can be downloaded from the AFM website: http://www.financialmutuals.org/files/files/AFM%20corporate%20governance%20code%2C%20jan19.pdf.

Each year members of AFM undertake a detailed review of their performance against the Code and report on the application of the key principles in their report and accounts. AFM reports on overall sector performance.

This paper should be read in conjunction with the AFM Corporate Governance Code, and our NED toolkit (versions January 2019).

This paper is designed to be helpful to our members, their NEDs and to the regulators, by helping to set out the duties they are obliged to undertake and the sources of those duties. **Duties of Directors of Mutual and Not-for-Profit Insurers and the NED toolkit are not designed to provide any information that would, or could reasonably be interpreted as, breaching confidentiality, data protection or competition laws.**

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