

Clients & Friends Memo

Shareholder Engagement with UK Companies – Proposed Changes to the Stewardship Framework

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Two UK regulatory bodies are currently consulting on rules relating institutional shareholders' engagement with and stewardship of their investee companies. The Financial Conduct Authority ("FCA") consultation paper¹ relates to proposed UK rules to implement the EU's revised Shareholder Rights Directive (the "Directive").² The Financial Reporting Council ("FRC")³ consultation paper sets out its proposals for revisions to the UK's Stewardship Code. At the same time the FCA and FRC issued a joint discussion paper⁴ on effective stewardship.

The FCA's proposal would impose legally-binding disclosure obligations on a subset of investors with respect to their stewardship objectives and activities, while the FRC's revised voluntary Stewardship Code provides a framework of "good stewardship" that is intended to set higher standards (and thus be a stamp of quality for those that sign).

The Current Situation. The FRC currently maintains a voluntary "Stewardship Code" that has 280 signatories that have undertaken to adhere to its principles. Quality of signatories' Code statements are publicly ranked by the FRC as "Tier 1" or "Tier 2", with signatories who fail to meet Tier 2 requirements being removed from the signatory list. Under current FCA rules, UK-authorized asset managers are required to disclose whether they adhere to that Code, and if not, why not. Though the UK was viewed as a first mover in recognising the importance of investors' engagement and influence when the FRC originally published its Stewardship Code in 2010, the regime's adequacy has been questioned in the recent government-commissioned Kingman Review⁵.

¹ FCA CP19/7

² Directive 2017/828

³ FRC: Consulting on a revised UK Stewardship Code

⁴ FRC, FCA Discussion Paper DP19/1

⁵ Independent Review of the Financial Reporting Council, published 18 December 2018.

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The Proposals.

Mandatory Reporting for FCA-Regulated Entities. The FCA proposal would implement relevant parts of the Directive into UK law. FCA-regulated asset managers (both UK and non-EEA firms) and life-insurers (“asset owners”) would be subject to the rules in respect of shares held by them in companies with a primary or secondary listing on an EEA market or a comparable market outside the EEA (which could include comparable US stock exchanges). Under the proposed rules:

- *Disclosure and Reporting on Engagement Policy and Voting Record.* Both asset owners and asset managers would have to have and disclose, on a comply-or-explain basis, a detailed “engagement policy” setting out how it monitors its investee companies on various matters, engages with and exercises voting rights in respect of those companies, cooperates with other shareholders, communicates with relevant stakeholders and manages conflicts of interest. They would also have to disclose annually how they have implemented this engagement policy, along with certain detailed voting information in respect of all but insignificant votes, which will not be defined. The information must be freely available on the firm’s website, with a reference or link by an asset owner to the asset manager’s reporting if that asset manager implements the owner’s engagement policy.
- *Expansion of Reporting from Asset Manager to Asset Owner: Alignment of Strategy with Long-Term Client Performance; Portfolio Information; Investment Decision Information.* Asset managers would have to report to asset owners how the asset manager’s investment strategy and implementation contributes to the medium- to long-term performance of the asset owner, as well as a list of information about their investments, including portfolio composition, turnover and turnover cost, use of proxy advisors and policy on securities lending, as well as any conflicts of interest. There will also be an obligation to report how (or whether) investment decisions are made on evaluation of medium- to long-term performance, including non-financial performance of the investee companies. It is not proposed to define these terms. The FCA acknowledges that some of this information may already be provided by asset managers to investors, and if so the proposal will not require any change, as no particular form of information provision is required under these proposals.
- *Additional Public Disclosure by Asset Owners: Alignment of Strategy with Liability Profile and Long-term Performance; Oversight of Asset Managers.* Asset owners would have to make public disclosure setting forth how the main elements of their equity investment strategy are consistent with the profile and duration of their long-term liabilities, and contribute to performance of their medium- to long-term assets. They would also be obligated to disclose, on a comply or explain basis, how their arrangements with asset managers (including, if relevant, their investments in any asset managers) meet a detailed list of criteria, including incentivizing the asset manager correctly, evaluating the manager’s performance in light of the profile of the asset owner’s liabilities, monitoring costs and turnover, and disclosing the duration of such arrangements.

Voluntary Stewardship Code. The proposed changes to the Stewardship Code expand and reorganize the existing Code to set “new and substantially higher expectations” for stewardship

which would be applicable to signatories in addition to any legally-mandated obligations pursuant to the Directive or otherwise. Whereas previously the Code focused on stewardship of investments in UK-listed equity, it would now apply to signatories in respect of all of their investments where they have rights or are able to exert influence.

- *Broader Notion of Stewardship and “Value Creation”.* The FRC is consulting on their proposed re-definition of the meaning of stewardship. The proposed new definition is “the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society”. For the first time it explicitly recognizes that the allocation, as well as management, of capital is a part of an investor’s stewardship duties. It also sets the purpose of stewardship as sustainable value creation not just for investment beneficiaries (or investee companies) but also the economy and society, and for the first time explicitly requires investors to show how they take into account ESG factors, including climate change.
- *Setting Policy and Integrating it to Internal Processes.* The “Principles” of the revised Code are binding on an “apply and explain” basis on signatories, and include an undertaking to set and disclose an organizational purpose and show how their strategy, values and culture enable them to fulfil their stewardship objectives and how their processes (including remuneration) support them.
- *Reporting and Monitoring.* Signatories would be required to submit an initial “Policy and Practice Statement” and at the end of each year confirm that statement. Signatories would also be required to submit an “Annual Activities and Outcomes Report”, which will be made publicly available, describing their compliance with their statement, their stewardship activities and outcomes, and a self-evaluation. Signatories need not comply with a specific reporting format and may reference certain other reports and disclosure where it meets the criteria of these reports.
- *Monitoring.* With proper reporting against the revised Stewardship Code, the FRC believes it will be possible for the reader to more accurately assess the signatories’ stewardship credentials for themselves, and its stated aim is to create a market in stewardship through this mechanism. The FRC does not seek to insert its own judgment as to the effectiveness of a signatory’s stewardship, but will continue to take a role in assessing how well the signatories fulfil reporting obligations. It may consider highlighting the signatories that report particularly well or poorly, and publishing thematic reviews on the reports against particular Principles or Provisions.

Reflections. There is uncertainty over whether either set of proposals will be implemented. A no-deal Brexit may mean the end of the FCA’s implementation of the Directive and the continued existence of the FRC itself is under threat following the Kingman review. However, these proposals signal that increased focus of lawmakers and regulators on corporate governance and asset manager oversight is here to stay, and these proposals reflect a view that, at least when investing on behalf of others, investors have responsibilities broader than seeking return.

There is, as the proposals and joint discussion paper recognize, no one-size fits all standard for good stewardship. Notably, these proposals do not mandate investment managers to exercise their stewardship responsibilities in any specific manner. Instead, the primary objective of these proposals is to provide investors with a framework for stewardship best practices and greater transparency as to how investment managers are exercising such stewardship responsibilities. Once armed with this information, investors may select an investment manager whose stewardship style aligns with their own goals and priorities. Our expectation is that, if implemented, these proposals will create a market for “good” stewardship and make the stewardship efforts of institutional investors more measurable and comparable. Moreover, we would expect these proposals to have the effect of directing greater levels of capital towards good stewards and causing investment managers to increase the focus placed on their stewardship functions.

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