

SHAREHOLDER RIGHTS DIRECTIVE II AND ITS IMPLICATIONS FOR ASSET MANAGERS

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UK Investment Management Alert

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The revised Shareholder Rights Directive (EU) 2017/828 [1] ("SRD II") is required to be transposed into the laws of EU member states by 10 June 2019. In the UK, the Financial Conduct Authority (the "FCA") consulted on changes to its rules to implement SRD II [2] and published final rules in a policy statement released on 31 May 2019 [3]. The rule changes will come into force on 10 June 2019.

In the circumstances the FCA is affording asset managers some leniency with respect to updating their shareholder engagement policies. Asset managers should be taking the following steps:

- Updating their shareholder engagement policies.
- Making any consequential changes to their shareholder engagement practices.
- Making arrangements to collate and publish the information needed for annual reporting requirements.

BACKGROUND TO SRD II

The European Parliament and the European Council adopted the Shareholder Rights Directive [4] ("SRD") in 2007. The aim of SRD was to improve the corporate governance of EU companies which traded on EU regulated markets by enabling shareholders to exercise their voting rights and rights to information across borders.

In 2014, the European Commission published an impact assessment identifying a number of problems in the area of corporate governance. In particular, the Commission concluded that asset managers and institutional investors (including life insurers and pension funds) often do not engage sufficiently with the companies in which they hold shares, and identified evidence showing that capital markets often exert pressure on companies to perform in the short term. SRD II aims to address these concerns in a number of ways, including by improving the transparency of asset managers' engagement policies and the implementation of those policies.

IMPLEMENTATION OF SRD II IN THE UK

Certain aspects of SRD II are directly implemented in EU member states by Commission Implementing Regulation (EU) 2018/1212 [5], including provisions intended to facilitate the exercise of voting rights by investors. Key aspects of SRD II that are not being directly implemented and therefore require implementation in each EU member state are those concerning asset managers' and institutional investors' shareholder engagement policies.

In the UK, the FCA is amending its rules to implement SRD II. The key elements of the rule changes are as follows:

- For asset managers and life insurers regulated by the FCA, new requirements regarding the public disclosure of their shareholder engagement policies, and periodic public disclosure of the implementation of such policies.
- For life insurers regulated by the FCA, new requirements regarding the public disclosure of their equity investment strategy and their arrangements with asset managers.
- For asset managers regulated by the FCA, new requirements regarding the disclosure to asset owners of the manager's shareholder engagement activities.
- For UK companies with shares admitted on a regulated market, requirements regarding the disclosure and approvals required for related party transactions.

In this alert, we focus on the requirements regarding the transparency of asset managers' shareholder engagement policies and practices.

SHAREHOLDER ENGAGEMENT TRANSPARENCY REQUIREMENTS UNDER SRD II

Scope of transparency requirements

The transparency requirements under the FCA rules will apply to asset managers, meaning MIFID investment firms, alternative investment fund managers (AIFMs) (excluding small AIFMs), UCITS management companies, self-managed UCITS funds and FCA-regulated insurers. Whilst this may not cover the full universe of institutional investor, the SRD II changes should be considered alongside the Financial Reporting Council's revisions to its Stewardship Code (discussed below).

Under SRD II, the requirements apply with respect to investee companies whose shares are admitted to trading on a regulated market in the European Economic Area ("EEA"), which the FCA regards as including overseas companies with a secondary listing in the EEA. In addition, in the UK the FCA is extending the requirements to investee companies whose shares are listed "on a comparable market outside the EEA".

Engagement policy

Asset managers and life insurers will be required to develop and publicly disclose their policy on shareholder engagement. The engagement policy should include the ways the firm:

- integrates shareholder engagement in its investment strategy;
- monitors investee companies, including their (i) strategy, (ii) financial and non-financial performance and risk, (iii) capital structure, (iv) social and environmental impact, and (v) corporate governance;
- conducts dialogue with investee companies;

- exercises voting rights and other rights attached to shares;
- cooperates with other shareholders;
- communicates with relevant stakeholders of the investee companies; and
- manages actual and potential conflicts of interest in relation to the firm's engagement.

The engagement policy must be disclosed on the firm's website. The requirement will apply on a 'comply or explain' basis. If a firm does not comply with one or more requirements, it must publicly disclose with a clear and reasoned explanation why they have chosen not to do so.

Firms will need to review their existing engagement policies to identify whether they comply with these requirements of SRD II. The FCA indicated in its policy statement that if firms have not updated their shareholder engagement policy by 10 June 2019, for an initial period those firms may choose to explain on their website that an updated policy is in the process of being developed or that the firm is considering whether or not to have one.

Implementation of engagement policy

Asset managers and life insurers will be required to publicly disclose how their engagement policy has been implemented, including:

- a general description of voting behaviour;
- an explanation of the most significant votes they have participated in;
- an explanation of their use of proxy advisors; and
- how they have cast votes at the general meetings of companies in which they hold shares (subject to an exception for "insignificant votes").

In response to the request for guidance on the meaning of "insignificant votes", in its policy statement the FCA did not provide any additional guidance, but pointed to the recitals to SRD II, which state that a vote may be insignificant either due to the subject matter of the vote or the size of the holding of the company.

This information is required to be made available free of charge on the firm's website.

Disclosure of investment strategy by life insurers

Life insurers will be required to publicly disclose certain information regarding their arrangements with the asset managers they appoint. This includes information relating to:

- how the arrangement with the asset manager incentivises the manager to align its investment strategy and decisions with the profile and duration of the life insurer's long-term liabilities;
- how the method and time horizon of the evaluation of the asset manager's performance and remuneration for the asset management services are in line with the profile and duration of the liabilities of the life insurer;
- how it monitors portfolio turnover costs incurred by the asset manager and how it defines and monitors a targeted portfolio turnover or turnover range; and

- the duration of the arrangement with the asset manager.

The information is required to be made available free of charge on the life insurer's website and updated on an annual basis. The requirement will apply on a 'comply or explain' basis.

Transparency of Asset Managers

To help asset owners (institutional investors) evaluate whether asset managers act in their best long term interests, asset managers will be required to disclose to certain types of institutional investor various information on at least an annual basis. That information must include:

- how their investment strategy and their implementation thereof contributes to the medium to long-term performance of the assets of the institutional investor or the fund;
- certain key information, including (i) key material medium to long term risks associated with the investments, (ii) portfolio composition, (iii) turnover, (iv) turnover costs, (v) the use of proxy advisors for the purpose of engagement activities, (vi) the firm's policy on securities lending and how it is applied to fulfil its engagement activities if applicable;
- whether, and if so, how the asset manager makes investment decisions based on evaluation of medium to long term performance of the investee company including non-financial performance; and
- whether any conflicts of interest have arisen in connection with their engagement, and if so, how the asset manager has dealt with these conflicts.

The FCA does not prescribe how these disclosures should be provided, but does indicate that where the information is available publicly, the asset manager is not also required to provide the information directly to institutional investors.

STEWARDSHIP CODE

Alongside the FCA's consultation paper on SRD II, the Financial Reporting Council ("FRC") published its consultation paper regarding revisions to the UK Stewardship Code [6], and a joint FRC/FCA discussion paper [7] entitled "Building a regulatory framework for effective stewardship" that seeks to encourage institutional investors to engage more actively with the companies in which they invest to promote sustainable long-term value creation.

With respect to the interaction between the SRD II and the Stewardship Code, the FCA has said that the implementation of SRD II sets an important baseline in a continuum of measures to drive effective stewardship. The revised Stewardship Code is intended to encourage higher standards beyond that baseline. Managers should note that institutional investors will be expected to enquire regarding an asset manager's compliance with the FRC Stewardship Code.

WHO TO CONTACT

Should you require any further guidance on the matters raised above please feel free to reach out to the contacts below.

NOTES

- [1] <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN>
- [2] <https://www.fca.org.uk/publication/consultation/cp19-07.pdf>
- [3] <https://www.fca.org.uk/publication/policy/ps19-13.pdf>
- [4] <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32007L0036>
- [5] <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1212>
- [6] <https://www.frc.org.uk/getattachment/bf27581f-c443-4365-ae0a-1487f1388a1b/Annex-A-Stewardship-Code-Jan-2019.pdfv>
- [7] <https://www.fca.org.uk/publication/discussion/dp19-01.pdf>

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