Client Briefing
April 2019

AIFMs and UCITS Managers: New Stewardship Regime

The EU Revised Shareholder Rights Directive (Directive 2017/828) ("SRD II") will be transposed into UK law by 10 June 2019. SRD II aims to promote effective stewardship and long-term investment decision-making. Primarily, it aims to achieve this by enhancing transparency of engagement policies and investment strategies across the institutional investment community. This Client Briefing is intended for our hedge fund and UCITS clients.

What is Stewardship? In its revised Stewardship Code, the Financial Reporting Council ("FRC") defines stewardship as the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities. The FCA has adopted this definition.

Context. According to the FCA, implementation of SRD II will be an "important baseline" for stewardship and the UK Stewardship Code (the "Code") will operate as a supplement, promoting higher standards. The Code was first published in 2010 to improve long-term returns to beneficiaries by enhancing the quantity and quality of engagement between investors and companies. FCA Rules (COBS 2.2.3R) require certain firms to disclose either the nature of their commitment to the Code or, where they do not commit to the Code, their alternative investment strategies. The FRC now plans to revise the Code, and has just completed a related consultation exercise. The Client Briefing considers the baseline requirements of SRD II.

Who? The draft FCA Rules (COBS 2.2B) apply to UK MiFID investment firms that provide portfolio management services to investors; third country investment firms that provide portfolio management services to investors; UK UCITS management companies; ICVCs that are UCITS schemes without separate management companies; and full-scope UK AIFMs.

What? The draft FCA Rules apply to the extent that the firm is investing (or has invested) in shares traded on a "regulated market." Here, the FCA proposes that a "regulated market" will have an extended meaning so that the rules will apply to shares held by regulated firms in all investee companies admitted to trading on an EEA regulated market or on a comparable market outside the EEA.

Where? The draft FCA Rules will apply to activities carried on by a firm from an establishment in the United Kingdom or activities carried on by a UK firm from an establishment in another EEA State.

"Comply or Explain". A firm must either: (1) (a) develop and publicly disclose an engagement policy that meets the requirements of the rules (an "engagement policy"); and (b) publicly disclose on an annual basis how its engagement policy has been implemented in a way that meets the requirements of the rules; or (2) publicly disclose a clear and reasoned explanation of why it has chosen not to comply with any of the requirements imposed by (1).

Engagement Policy. The engagement policy must describe how the firm: (1) integrates shareholder engagement in its investment strategy; (2) monitors investee companies on relevant matters, including: (a) strategy; (b) financial and non-financial performance and risk; (c) capital structure; and (d) social and environmental impact and corporate governance; (3) conducts dialogues with investee companies; (4) exercises voting rights and other rights attached to shares; (5) cooperates with other shareholders; (6) communicates with relevant stakeholders of the investee companies; and (7) manages actual and potential conflicts of interests in relation to the firm's engagement.

Annual Disclosure. The annual disclosure must include a general description of voting behaviour, an explanation of the most significant votes and reporting on the use of the services of proxy advisors. A firm must publicly disclose how it has cast votes in the general meetings of companies in which it holds shares, provided that it is not required to disclose votes that are insignificant due to the subject matter of the vote or the size of the holding in the company.

When? The proposed rules will come into effect on 10 June 2019 to meet the transposition deadline for SRD II. However, the FCA has said that for an initial period after they come into effect, it will consider that it would be possible for a firm to comply with the relevant rules by explaining what it is doing to develop an engagement policy.

Next Steps. Subject to any changes that the FCA makes to the final form of the rules, clients will need to:

1. Review existing engagement policies to identify whether they comply with the full requirements of the new rules; or, where they do not have engagement policies, develop an engagement policy that meets the requirements of the rules or produce a "clear and reasoned explanation" of why they have chosen not.

2. As part of this process, affected clients will need to consider at what level to disclose their engagement policy, for example at group level or product level.

3. Consider whether any changes need to be made to underlying asset-related agreements, including custody, depositary, prime brokerage agreements and securities lending agreements.

4. Consider whether current offering document disclosures are consistent and adequate.

If you require advice on this new regulatory regime, or if you wish to discuss these matters in more detail, please contact your relationship partner or Dan Harris at daniel.harris@chanceryadvisors.com.

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