SLAUGHTER AND MAY

The UK Stewardship Code 2020: Some key points

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Background

The long awaited UK Stewardship Code 2020 (the "Code") was published by the Financial Reporting Council (FRC) on 24 October 2019. Given significant developments in sustainable finance, responsible investment and stewardship since 2012 when the Stewardship Code was first introduced, it was long due for an overhaul.

The initial consultation on revisions to the Code ("Consulting on a revised Stewardship Code", published in January 2019) attracted substantial interest, with more than 100 responses from a wide range of stakeholders. The FRC noted that it met more than 150 stakeholders during the consultation period and nearly 90 parties in further research afterwards.

The Code, which takes effect for reporting years beginning on or after 1 January 2020 is, of course, voluntary but there is an existing requirement in the Financial Conduct Authority's (FCA) Conduct of Business Sourcebook (COBS 2.2.3) for an asset manager (in its capacity managing investments for professional clients) to disclose the nature of its commitment to the FRC's Stewardship Code (or if it does not commit to the Code, its alternative investment strategy). The FRC will no longer accept new or updated statements against the 2012 Code after 31 December 2019.

The FCA has also published its Feedback Statement (FS 19/7) to Discussion Paper (DP 19/1) on "building a regulatory framework for effective stewardship".

Some key points on the revised Code and the FCA Feedback Statement are set out below.

Definition of stewardship

The definition of "stewardship" has been revised following extensive feedback. This now reads as follows:

"Stewardship is the responsible allocation, management *and oversight* of capital to *create long-term value for clients and beneficiaries* <u>leading to</u> sustainable benefits for the economy, environment and society."

The definition that was initially proposed defined stewardship as "the responsible allocation and management of capital across the institutional investment community to <u>create sustainable value for beneficiaries, the economy and society</u>." While many respondents agreed that there should be references to wider economic and social considerations in the definition, they were concerned that the proposed definition elevated the creation of sustainable value "for the economy and society", giving *equal* prominence to the interests of beneficiaries and to those of the wider economy and society. Many did not see this as part of the <u>primary</u> aim of stewardship. Instead the primary aim should be the delivery of sustainable financial returns to clients and beneficiaries, although it was acknowledged that in achieving this aim, there may be positive impacts for the economy and society. Other respondents were more positive towards the proposed definition, noting that having regard to the wider economy and society was consistent with exercising good stewardship and in line with an asset manager's fiduciary responsibilities. Even so, arguably "having regard to" is not the same as having to "create sustainable value for" the economy and society. Similar responses were received in relation to DP 19/1, which presented the same definition as that proposed in FRC's consultation. The FRC has revised the definition accordingly following the feedback. Note the definition now includes a reference to the “environment” as well.

Structure of the Code

The Code has been completely restructured:

- It now comprises 12 "apply and explain" Principles for asset managers and asset owners (institutional investors such as life insurers) with accompanying “reporting expectations”, rather than the 10 “apply and explain” Principles, with supporting “comply or explain” provisions, as originally proposed. There are 6 separate Principles that apply to service providers (such as proxy advisers).
- The Provisions have been incorporated into the Principles or as reporting expectations.
- There is no separate guidance but examples are incorporated into the reporting expectations.

The Code operates on an “apply and explain” basis – i.e. signatories have to apply the Principles AND explain how they have done so. Supporting “comply or explain” provisions have been omitted and instead the Principles are supported by a number of reporting expectations (see further in “Content of the Code” below). This change reflects feedback received that the draft proposals were too detailed, had too many Provisions, and that the Code would benefit from a simpler structure.

There is recognition that signatories will not exercise stewardship in an identical way given the huge variation in size, business models and investment strategy of asset managers and owners. In its restructured form, the Code allows some flexibility, with a Principles-based approach seen as being less prescriptive. That said, the “reporting expectations” do set out the type of information the FRC expects to see in each Stewardship Report (see further in “Content of the Code” below).

The 12 Principles apply equally to asset owners and asset managers, but some reporting expectations differ according to whether the organisation is an asset owner or asset manager. It was acknowledged that some organisations may do both, in which case the expectation is that they should fulfil ALL the reporting expectations that apply to them.

Content of the Code

As noted, the Code is organised around Principles, with a number of “reporting expectations” under each Principle setting out what is expected to be reported when a signatory organisation explains its application with those Principles. The focus is very much on reporting on “activities” and “outcomes” (i.e. on the actual activities the organisation has undertaken over the year as it applies each Principle and the outcomes it achieved from those activities) rather than just disclosing what “policies” it has in place.

Some points of note:

- Signatories need to explain their “purpose and outline their culture, values, business model and strategy” as well as their “investment beliefs” (i.e. what factors they consider important for desired investment outcomes) and explain what actions they have taken to ensure these enable them to exercise effective stewardship (activity) and how the purpose and beliefs have guided their investment decisions and an assessment of how effective these have been in serving the best interests of clients and beneficiaries (outcome).
- Signatories need to report on their governance structures and processes which enable oversight/accountability for stewardship, the resourcing of their stewardship functions (their workforce structures, seniority and qualifications of those responsible for stewardship, what training is in place, etc.) and how their workforce has been incentivised to integrate stewardship and investment decision-making.
- Signatories are expected to systematically integrate stewardship into their investment approach, and explicit reference is made to

including environmental, social and governance (ESG) issues, and climate change matters, when assessing and monitoring investments.

- As part of the Principle requiring them to actively exercise their rights and responsibilities (Principle 12), signatories have to explain how they exercise stewardship across other asset classes (in particular, fixed income), and not just for listed equities. There are more detailed reporting expectations for listed equities, including the need to disclose their voting policy, report on the extent to which they use default recommendations of proxy advisers, as well as a link to their voting records and an explanation for some or all of their voting decision. For fixed income, signatories should explain their approach to a number of matters, including: seeking amendments to terms and conditions in debt instruments, impairment rights, and reviewing of prospectuses.

Reporting requirements

The initial proposal required signatories to produce an initial Policy and Practice Statement (on signing up to the Code) to be followed by an Activities and Outcomes Report 12 months later (which must be produced on an annual basis thereafter) showing what activities they have undertaken and what outcomes have been achieved in accordance with their stewardship policies. This proposal has been dropped - signatories are now required to submit only one (annual) "**Stewardship Report**" which sets out how they have applied the Code in the preceding 12 months. This is meant to simplify reporting for signatories.

The Report is the means by which the FRC assesses whether an organisation has met its expectations to become a signatory and then after to remain a signatory. Originally, firms were required to submit their first Stewardship Reports *by* 31 December 2020 but now firms applying the Code for the year beginning 1 January 2020 have until 31 March 2021 to submit their final report to the FRC, which will then publish a list of initial signatories in Q3 2021. Those submitting after this date can subsequently be added to the list.

Reports should be:

- a single document and "stand-alone" (i.e. it should enable the reader to understand how the firm has applied the Code without having to refer to information elsewhere), although links to more detailed policies and disclosures are permitted.
- "succinct" and in "plain English" as well as "fair, balanced and understandable". This requirement to be "fair and balanced" means that it include examples of unsuccessful outcomes and "lessons learned", as well as successful outcomes. It was noted that stewardship activities may take more than a year and may not be completed within the reporting period – if so, this should be indicated and progress reported.
- approved by the board and signed by the chair, CEO, or CIO.

There is no need for asset managers to disclose stewardship activities on a fund-by-fund basis although there should be an indication of how stewardship activities differ across funds, asset classes and geographies (in a manner proportionate to their operations).

Interaction with the EU Shareholder Rights Directive II (SRD II)

SRD II puts on a legal footing a requirement for asset managers and asset owners to develop and explain how they have implemented an engagement policy for their listed equity investments. Since the Code goes beyond these "baseline" requirements under SRD II, it is likely that compliance with the Code will satisfy the SRD II disclosure requirements. However, the FRC will not assess signatories' compliance with the SRD II requirements (which is a matter for the FCA and the Pensions Regulator).

There is nonetheless some acknowledgement of this overlap - the Code states that signatories may use the Stewardship Report to disclose information to meet other stewardship-related regulatory requirements (the Annex expressly notes other regulatory requirements for the different categories of signatories, including SRD II requirements as transposed in the FCA's Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) for certain regulated asset owners and Conduct of Business Sourcebook (COBS) for asset managers). Although firms need to make their own assessment of whether the disclosures included satisfy the SRD II requirements, the Stewardship Report should serve the dual purpose of also enabling asset owners and asset managers to satisfy SRD II requirements.

Feedback on DP 19/1 (FS 19/7) and the Stewardship Code

Against the wider context of various initiatives to promote a long-term perspective in investment activity (to which stewardship is seen as integral), DP 19/1 was published jointly by the FCA and the FRC in January 2019 alongside FRC's consultation on revisions to the Stewardship Code and the FCA's consultation on measures to implement SRD II. The Discussion Paper sought views on wider issues on how best to encourage the institutional investment community to engage more actively in stewardship, in particular examining: (i) what constitutes effective stewardship; (ii) what the minimum expectations should be for financial services firms that invest for clients and beneficiaries; and (iii) the standards that the UK should aspire to and how to achieve them.

While respondents generally agreed with FCA's view in the Discussion Paper on the role stewardship can play in helping make relevant markets function well, most were against the introduction of further stewardship requirements for asset managers or life insurers at this point, particularly given new rules implementing SRD II and other related measures in this area are yet to bed in. The FCA has therefore decided that it should not introduce new regulatory measures now, but has set out a number of actions it will take to address some identified barriers to effective stewardship, including continuing engagement with the FRC as it introduces the new reporting expectations under the revised Code, and with firms as part of its supervisory work. It was noted that firms' disclosures under both SRD II rules and the UK Stewardship Code 2020 would support that supervisory work.

With the recognition that effective stewardship requires a system-wide approach that encompasses all members of the institutional investment community, what is clear is that the Stewardship Code is simply one piece of a wider framework that the government, regulators and industry bodies are attempting to establish to support effective stewardship. Asset managers, their institutional investor clients and other service providers to the investor community should not be surprised to see more measures and initiatives being introduced in this area.

If you would like to discuss any of the points raised in this briefing, please do contact one of us or your usual Slaughter and May contact.

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