October 28, 2019

UK REGULATORS MAKE FURTHER STRIDES IN RESPONSIBLE STEWARDSHIP & INVESTING

To Our Clients and Friends:

The UK's Financial Reporting Council ("FRC")[1] published on 24 October 2019[2], a revised version of its stewardship code – the UK Stewardship Code 2020 (the " New Code") which takes effect in January 2020. On the same day, the UK Financial Conduct Authority ("FCA") published the results of the feedback from its joint initiative with the FRC, seeking views of the market on a minimum standards regulatory framework for stewardship for financial services firms that invest for clients and beneficiaries[3]. The New Code (which covers a broader asset class than just listed equity) firmly entrenches the UK as a leader in shareholder engagement and stewardship – with a strong focus on outcomes (and not just policy statements) of stewardship, and lays out new expectations on how investment and stewardship is integrated, including environmental, social and governance ("ESG") issues. The FCA has concluded that at this stage, given other recent new regulatory requirements, it does not propose to introduce further (stewardship-related) regulatory requirements on regulated asset managers and insurers, however it has flagged a number of key areas where it considers that barriers to effective stewardship remain and should be addressed.

This alert summarises the key changes in the New Code impacting investors and asset managers, the outcomes from the FCA/FRC discussion paper and related recent and forthcoming UK and EU legal and regulatory developments.

A. The UK Stewardship Code – Background and Developments

The UK Stewardship Code was first published in 2010 following the 2009 Walker Review[4] on governance of financial institutions in the wake of the global financial crisis, with a view to enhancing the quantity and quality of engagement between investors and companies. At the time, it was the first and only Stewardship Code[5] calling for responsible and engaged investment behaviours by asset managers and owners. In 2012, following the Kay Review of UK equity markets[6], the Code was revised to expand the role of stewardship and require investors to engage with companies on strategy as well as corporate governance. Since the revision of the Code in 2012 (the "Current Code"), the UK has continued to be seen as a market which upholds high standards of corporate governance and therefore attract international investors. By 2016, there were 305 signatories to the Code however upon evaluation by the FRC of the signatories' statements against the Current Code, the FRC noted a huge variation in quality of the signatories' stewardship statements. In that year, the FRC introduced a two tier/ranking system – signatories to the Code in Tier 1 were recognised as having achieved the status of reporting well and those in Tier 2 were flagged as signatories whose statements required improvement.

Notwithstanding these enhancements and resulting improvements in stewardship, examples of poor governance practice, short-termism in equity markets and misalignment of incentives leading to under-performance and corporate failures persisted. The FRC has also recognised that the investment market has materially altered since the first Code was published with increased investment flows into assets other than listed equity and environmental (particularly climate change) and social factors becoming more material issues for investors, in addition to the pre-existing focus on governance. Alongside this, there have been a number of developments in the UK, EU and global level aimed at enhancing resources for stewardship, increasing transparency and engagement between asset owners and asset managers, enhancing climate change and other non-financial disclosures and incorporating ESG considerations into the mainstream. These drivers and developments collectively led to the FRC to consult on some fundamental revisions to the Current Code. It has done this in parallel with its related joint initiative with the FCA seeking views on how best to encourage the institutional investment community to engage more actively in stewardship, the outcomes of which are summarised in section C below.

The FRC issued its consultation paper in January 2019[7] and received 110 responses to its consultation which closed in March of this year. In preparing for the consultation it reached out and sought feedback from 170 members of the global investment community (including the UN PRI, ShareAction, the Investment Association and the UK Sustainable Investment and Finance Association). It also met with circa 240 stakeholders as part of and following the launch of the consultation process. The consultation responses reflected strong support for the key changes (summarised in section B below).

B. The New UK Stewardship Code 2020

Who does it apply to? Who should be interested in it? The New Code is a voluntary code which sets higher standards than minimum UK regulatory requirements for asset owners[8] and managers and for the service providers[9] who support them.

What does the New Code do/say? The New Code is structurally and substantially very different from the Current Code.

First and fundamentally, the New Code sets out a new definition of stewardship[10]. Stewardship is now defined as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to <u>sustainable benefits for the economy, the environment and society</u>." This new definition links the primary purpose of stewardship to looking after the assets of beneficiaries entrusted to other, equating long-term value creation for this cohort with sustainable benefits to a wider group of interests (i.e., the "economy, environment and society).

The New Code consists of 12 "apply or explain" Principles for asset managers and asset owners (see Annex 1). These are supported by reporting expectations which indicate the information that should be publicly reported in order to become a signatory. The Current Code has seven "comply or explain" principles that are aimed at protecting and enhancing the value that accrues to the ultimate beneficiary.

There is a strong focus on the activities and outcomes of stewardship, not just policy statements. There are new expectations about how investment and stewardship is integrated, including ESG issues – note in particular Principle 7.

The New Code[11] asks investors to explain how they have exercised stewardship across asset classes. For these purpose, the New Code extends the scope across asset classes beyond listed equity for example fixed income, private equity, infrastructure investments, and in investments outside the UK.

The New Code also sets out six separate Principles for service providers. These now include principles addressing the assurance and the role service providers play in responding to market and systemic risks. The FRC has also used the New Code as an opportunity to be clearer about its expectations on the role played by service providers in the supporting their clients to meet their stewardship and investment responsibilities "taking into account material ESG issues, and communicating what activities have been undertaken".

When does it apply from? The New Code will take effect from 1 January 2020. Organisations will remain signatories to the UK Stewardship Code until the first list of signatories to the New Code is published. To be included in the first list of signatories, organisations must submit a final report to the FRC by 31 March 2021.

How do firms apply to become signatories and what happens upon becoming a signatory? The New Code contains various reporting requirements. Organisations who wish to become signatories should produce a single[12] Stewardship Report explaining how they have applied the New Code in the previous 12 months for approval by the FRC. The Report should be reviewed and approved by the organisation's governing body and signed by the chair, CEO or CIO. Existing signatories[13] to the Code will also need to submit a Stewardship Report that meets the reporting expectations in the New Code, in order to be listed as signatories to the UK Stewardship Code. Throughout 2020, the FRC has said that it will work with organisations seeking to be listed as signatories (in particular asset owners) to explain their expectations in relation to reporting.

Once an organisation has been accepted as a New Code signatory and the report is approved by the FRC, the report will be a public document and must be published on the organisation's website or in some other accessible form.

C. FCA & FRC Feedback On & Outcomes From the "Building a Regulatory Framework for Effective Stewardship" Discussion Paper

The FCA is the conduct regulator for 59,000 financial services firms and financial markets in the UK and the prudential regulator for over 18,000 of those firms. One of its primary objectives is to make markets work well – for individuals, for business, large and small, and for the economy as a whole. Specifically, the FCA aims to ensure that firms such as asset managers and life insurers deliver good outcomes for their customers. For many firms, the exercise of stewardship will be key to ensuring this outcome. The FCA has also stated that it expects "effective stewardship to have wider economic, environmental and social benefits".

In delivering on its regulatory responsibility to ensure effective stewardship, in January 2019, the FCA issued a Discussion Paper (closely co-ordinating with the FRC), 'Building a Regulatory Framework for Stewardship'. The objective of the Discussion Paper was to secure feedback on barriers to effective stewardship, the minimum expectations on effective stewardship that should be imposed on financial services firms investing on behalf of clients and how to achieve them.

On 24 October, the FCA published the feedback from the Discussion Paper exercise[14]. In summary, the FCA agreed with the feedback from the majority of respondents that it would be premature to impose more stewardship obligations or requirements of asset managers and life insurers at this stage and that it should let firms first adapt to the FCA's new rules on shareholder engagement (implementing SRD II – see section D below) which took effect in June. Further, the FCA noted that many firms were already making significant investments to improve their stewardship capabilities with an enhanced focus on ESG matters.

Notwithstanding this general finding, the FCA also concluded that there were other things that it could do to address some "remaining barriers to effective stewardship", including: (i) examining how asset owners set and communicate their stewardship objectives; (ii) helping to address regulatory, informational and structural barriers to effective stewardship practices; (iii) considering further the role of firms' culture, governance and leadership in both the management of climate risks and the exercise of stewardship; and (iv) pursuing a number of actions to promote better disclosure of firms' stewardship practices and outcomes.

Some of the specific actions the FCA are proposing to take and/or areas they intend to give greater attention and focus to relate to the following:-

Climate-change related & other sustainability disclosures by issuers: The FCA is intending to consult in early 2020 on proposals for new 'comply or explain' rules requiring climate change-related disclosures by certain listed issuers aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Alongside this, the FCA will continue to consider whether issuer disclosures on other sustainability factors, beyond climate change, are adequate to support investors' business, risk and investment decisions.

Climate-change related disclosures by regulated firms: The FCA will consider how best to enhance climate change disclosures by regulated firms, such as asset managers and life insurers, so that they provide transparency on how their activities align with clients' sustainability objectives

ESG Data Service Providers: The FCA will assess the role played by specialist providers of ESG data services looking initially at the nature and quality of these services, how investors use them and how much reliance they place on them.

Tackling "Greenwashing": The FCA intends to do more to promote consumers' access to genuinely green products and services; will "challenge firms" where it sees potential evidence of misleading marketing or "greenwashing"; carry out further policy analysis on greenwashing and publish new guidance as appropriate.

D. Recent Related UK/ EU Developments

As noted above, one of the key drivers to the review undertaken by the FRC of the Stewardship Code and the FCA of stewardship more generally, has been the link to the growing interest in how companies and investment firms manage climate change and other ESG risks and opportunities and related legal and regulatory developments in this area. A brief overview of some of these developments are noted below:

UK Law Commission Review of Fiduciary Duties of Investment Intermediaries: In 2014, the Law Commission reviewed the legal concept of fiduciary duty with regards to investment. It stated that 'there is no impediment to trustees taking account of ESG factors where they are, or may be, financially material' and recommended that the government should clarify that it is part of trustees' duties to consider long-term systemic risks such as climate change. In 2017, the Law Commission issued a further report – 'Pension Funds and Social Investment' which identified a critical distinction between ESG and ethical factors, and began to explore options for regulatory reform.

Pensions Regulator & UK Department of Work & Pensions (DWP) Strengthen Pension Trustees Investment Duties: In 2016 and 2017, the UK Pensions Regulator updated its guidance for defined contribution and defined benefit schemes, advising that trustees need to take all factors that are financially material to investment performance into account, including ESG factors. Then in 2018, in response to the Law Commission's report, the DWP issued amendments to the Occupational Pension Schemes Regulations[15] requiring trustees of funds to document in their Statement of Investment Principles how they have taken ESG factors in making investment decisions and their policy towards stewardship.

Shareholders Rights Directive II ("SRD II"): The EU Shareholder Rights Directive 2007 (SRD) aimed to improve corporate governance in EU companies by setting minimum EU standards on shareholder rights in relation to general meetings (including viz notice periods, information rights, requisitions, voting) and other matter such as website disclosures and proxy appointments. SRD II substantially amends SRD broadening its scope and remit to include rules to encourage long-terms shareholder engagement and transparency between traded companies and investors. The key changes introduced by SRD II which recently came into force in the UK (June 2019) include provisions relating to identification of shareholders, transmission of information between companies and their shareholders via intermediaries, obligations on intermediaries to facilitate stewardship or the exercise of rights by shareholders, disclosure obligations on proxy advisers, obligations relating to related party transactions, rights of shareholders to vote on remuneration policies and remuneration reports and (of particular relevance to the work of the FRC and FCA outlined above) new provisions on the transparency of engagement policies of institutional investors and asset managers as well as their investment strategies.

In particular, SRD II includes three key requirements relevant to transparency of engagement policies and investment strategies. First, institutional investors and asset managers are required to develop and disclose a shareholder engagement policy, as well as disclosing annually how they implement the policy and how they have voted in general meetings of companies of which they hold shares. The matters to be covered by the engagement policy are extensive including how institutional investors and asset managers integrate shareholder engagement in their investment strategy, monitor investee companies on relevant matters, conduct dialogues with investee companies, exercise voting and other rights, co-operate with shareholders, communicate with investee company stakeholders, and manage actual and potential conflicts of interest. In the UK, these rules apply to asset managers and insurers who have the UK as their home state regulator or investment firms authorized by the FCA.

Secondly, where an asset manager invests on behalf of an institutional investor, the institutional investor must disclose certain information regarding its arrangement with the asset manager (or explain why the information is not disclosed).The disclosure should include, for example, how the arrangement incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities. This information must be made freely available on the institutional investor's website.

Thirdly, asset managers disclose annually to the institutional investors for whom they invest how their investment strategy and implementation of that strategy complies with the arrangement with the institutional investor; and contributes to the medium to long-term performance of the assets of the institutional investor or fund. The disclosure must include key material medium to long-term risks associated with investments. The disclosures can be made publicly (e.g. in annual reports) or otherwise provided directly to the institutional investor.

UK Government Greenhouse Gas & Plastics Commitments: The UK Government has made a legally binding commitment to achieve net zero greenhouse gas emissions by 2050. It has also signed up to the UK Plastics Pact aimed at achieving four world-leading plastic packaging elimination targets by 2025.

UK Government Green Finance Strategy: In July 2019, the UK Government published its Green Finance Strategy[16] to support, amongst other things, its economic policy for strong, sustainable and balanced growth and its domestic and international commitments on climate change, the environment and sustainable development.

European Commission Sustainable Finance Action Plan: In 2015, the European Commission committed to the UN 2030 Sustainable Development Goals agenda and to achieving the 2030 Paris Agreement targets (including a 40% cut in greenhouse gas emission). The EC recognised that substantial investment would be required to achieve these targets and fulfil on its commitments. Accordingly, in 2016, it established a High Level Expert Group on Sustainable Finance which made a series of recommendations as set out in a wide-ranging Sustainable Finance Action Plan[17] which was formally adopted in May 2018. This includes work on sustainable finance disclosures, sustainable climate benchmarks, and a taxonomy to promote a common understanding of what constitutes sustainable activity. In May 2018, the EC adopted a package of measures implementing several key actions announced in its action plan on sustainable finance (see Section E below) and in August 2018, the European Commission mandated the European Securities and Markets Association ("ESMA") to prepare technical advice on how to require asset managers and advisers to integrate ESG risks in their investment decisions or advisory processes, as part of their duties towards investors and/or clients.

E. Upcoming UK/ EU Developments of Note

In addition to the various initiatives that the FCA has outlined in its Feedback Statement on the New Regulatory framework for Effective Stewardship (see section C above) and the actions flowing out of the EU's Sustainable Finance Action Pan (as summarised in section D above) there are a number of other initiatives and developments underway both in the UK and at an EU level. Some developments to keep an eye out for include the following:

FCA Consultation on Extending the Remit of Independent Governance Committees ("IGCs")[18] *ESG Duties*: The FCA is currently consulting[19] on imposing a new duty for IGCs to report on their firm's policies on ESG issues, consumer concerns and stewardship, for the products that IGCs oversee. The FCA is also proposing related guidance for providers of pension products and investment-based life insurance products which sets out how these firms should consider factors such as ESG risks and opportunities that can have an impact on financial returns, and to non-financial consumer concerns, when making investment decisions on behalf of consumers.

EU Sustainable Finance Action Plan – Specific Upcoming Regulations. Under the EU's Action Plan a number of legislative proposals have been made. These include:

- ***ESG Taxonomy Regulation - A proposal for the establishment of a framework to facilitate sustainable investment***[20]: This regulation establishes the conditions and the framework to gradually create a unified classification system or 'taxonomy' on what can be considered an environmentally sustainable economic activity. To be environmentally sustainable, an economic activity must: contribute substantially to one or more of six specified environmental objectives: (i) climate change mitigation; (ii) climate change adaption; (iii) sustainable use and protection of water and marine resources; (iv) transition to a circular economy, waste prevention and recycling; (v) pollution prevention and control; and (vi) protection of healthy ecosystems. Financial market participants offering financial products as environmentally-sustainable would be impacted by the proposed Taxonomy Regulation as they would have to disclose information on the criteria used to determine the environmental sustainability of the investment.

- ***ESG Disclosure Regulation - A proposal on disclosures relating to sustainable investments and sustainability risks***[21]*:* This regulation will introduce disclosure obligations on how institutional investors and asset managers integrate ESG factors into their risk management processes. The proposed regulation would cover all financial products offered and services (individual portfolio management and advice) provided by the entities listed below, regardless of whether they pursue sustainability investment objectives or not. The rules would impact the following entities: (i) asset managers, regulated under the directive on undertakings for collective investment in transferable securities (UCITS), the alternative investment fund managers (*AIFM*) directive, the European venture capital funds (EuVECA) and European social entrepreneurship funds (EuSEF) regulations; (ii) institutional investors (being insurance undertakings regulated by Solvency II and occupational pension funds regulated by the institutions for occupational retirement provision directive; (iii) insurance distributors regulated by the insurance distribution directive ("IDD"); and (iv) investment advisors and individual portfolio managers regulated by Markets in financial instruments directive ("MiFID II").

· ***ESG Benchmark Regulation - A proposal amending the benchmarks regulation***[22]: This amendment will create a new category of benchmarks comprising two new categories: (i) a low-carbon benchmark - this is a filtered version of a standard benchmark in which the underlying assets are selected so that the resulting portfolio has lower carbon emissions than the 'parent' standard benchmark; and (ii) a positive carbon impact benchmark - this is a more sustainability-focused benchmark, in which the underlying assets are selected on the basis that their carbon emissions savings exceed their carbon footprint. In addition, the regulation will require benchmark administrators to methodologies for the assessment, selection and weighting of the underlying assets comprising their individual versions of these benchmarks, and explain how such benchmarks reflect ESG objectives.

MiFID II & IDD: The European Commission has also launched a consultation to assess how best to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients. The aim is to amend Delegated Acts under the Markets in Financial Instruments Directive (MiFID II)[23] and the Insurance Distribution Directive (IDD)[24]. The Commission is of the view that when assessing if an investment product meets their clients' needs, firms should also consider the sustainability preferences of each client, according to the proposed rules. This should help a broader range of investors access sustainable investments.

By way of reminder, under the existing MiFID II "suitability framework", firms providing investment advice and portfolio management services are required to obtain information from clients about their knowledge and experience, ability to bear losses, their investment objectives including risk tolerance, to ensure that such firms recommend and/or trade products that are suitable for the client. The proposed changes to MiFID II would incorporate ESG considerations in the suitability framework. This would mean that portfolio managers and investment advisers will have to take steps to ensure that their clients' ESG considerations are captured and embedded in their investment decision and recommendations framework. Although clients would not be obliged to provide or specify their ESG considerations, firms would be required to proactively seek this information from clients and accordingly they will need to give consideration as to how best to ascertain and capture this information.

Timing & Conclusion: The EC hopes that the first delegated act covering the climate change adaptation and mitigation objectives could be adopted by the end of this year. The objective would be to adopt the second and third delegated acts by mid-2021 and mid-2022 respectively covering other four other environmental objectives (protection of water and marine resources, circular economy and waste management, pollution prevention and control, protection of water and marine resources, healthy ecosystems). The EU environmental taxonomy (which is the bedrock of a number of the current and proposed new measures under the EU's Action Plan) would then be completed. In a timing set-back, late in September 2019, member states of the EU voted to delay the application of the taxonomy to end 2022 – almost two years later than the Commission originally planned. Whilst the full package of proposals will take a few years to develop and be fully implemented, asset managers and investors are advised to start reviewing the impact of the new reporting and disclosure frameworks at an early stage to consider how these can be best embedded into existing frameworks and procedures.

ANNEX 1

UK Stewardship Code 2020 – New "Apply or Explain" Principles

Principles for Asset Owners and Asset Managers

Purpose and Governance

1. Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society
2. Signatories' governance, resources and incentives support stewardship.
3. Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.
4. Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.
5. Signatories review their policies, assure their processes and assess the effectiveness of their activities.

Investment approach

6. Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.
7. Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.
8. Signatories monitor and hold to account managers and/or service providers.

Engagement

9. Signatories engage with issuers to maintain or enhance the value of assets.
10. Signatories, where necessary, participate in collaborative engagement to influence issuers.
11. Signatories, where necessary, escalate stewardship activities to influence issuers.

Exercising rights and responsibilities

12. Signatories actively exercise their rights and responsibilities.

PRINCIPLES FOR SERVICE PROVIDERS

1. Signatories' purpose, strategy and culture enable them to promote effective stewardship.
2. Signatories' governance, workforce, resources and incentives enable them to promote effective stewardship.
3. Signatories identify and manage conflicts of interest and put the best interests of clients first.
4. Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.
5. Signatories support clients' integration of stewardship and investment, taking into account, material environmental, social and governance issues, and communicating what activities they have undertaken.
6. Signatories review their policies and assure their processes.

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[1] The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for auditing, accounting and actuarial work. It monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries and enforces audit quality.

[2] Revised version of stewardship code, here.

[3] Results of feedback from joint initiative with the FRC, here.

[4] A Review of Corporate Governance in UK Banks and Financial Institutions (26 June 2009) led by Sir David Walker, here.

[5] NB: There are now over 20 stewardship codes globally many of which have been based on the original UK Code.

[6] The Kay Review UK Equity Markets and Long-Term Decision Making: Final Report June 2012, here.

[7] FRC consultation paper issued January 2019, here.

[8] These include pension funds, endowment funds and charities.

[9] These include investment consultants, proxy advisers and data and research providers.

[10] The Current Code states that the aim of stewardship is "promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole."

[11] Principle 12.

[12] The Code does not require disclosure of stewardship activities on a fund-by-fund basis or for each investment strategy but does require the report to indicate how stewardship differs across funds, asset class and geographies.

[13] For list of existing (i) asset manager signatories, click here; (ii) asset owner signatories, click here; and (iii) service provider signatories, click here.

[14] FCA published feedback from Discussion Paper exercise, here.

[15] Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (the "Amending Regulations")

[16] July 2019 UK Government Green Finance Strategy, here.

[17] Sustainable Finance Action Plan, here.

[18] IGCs provide independent oversight of the value for money of workplace personal pensions provided by firms such as life insurers and some self-invested personal pension operators. They also oversee workplace personal pensions in accumulation, i.e., before pension savings are accessed.

[19] The FCA is currently consulting on imposing a new duty for IGCs to report on their firm's policies on ESG issues, consumer concerns and stewardship, for the products that IGCs oversee, here.

[20] ESG Taxonomy Regulation - A proposal for the establishment of a framework to facilitate sustainable investment, here.

[21] ESG Disclosure Regulation - A proposal on disclosures relating to sustainable investments and sustainability risks, here.

[22] For text of EU Low Carbon Benchmarks Regulation published on 25 October 2019, click here.

[23] Draft Amending Delegated Acts under MiFID II, here.

[24] Draft Amending Delegated Acts under the Insurance Distribution Directive, here.

To learn more about the issues covered in this alert, please contact the author of this alert, Selina Sagayam, or the Gibson Dunn lawyer with whom you usually work in the Securities Regulation and Corporate Governance practice group, or any of the following lawyers:

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