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KEY CHANGES TO THE UK STEWARDSHIP CODE

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The UK Stewardship Code 2020 (the **"Code"**) published on 24 October 2019, by the Financial Reporting Council (the "**FRC**") takes effect for reporting from 1 January 2020. The Code replaces the 2012 edition and sets out standards relevant to asset owners, asset managers and service providers. Ultimately, the purpose of the Code is to set out a framework for those organisations who are subject to regulatory requirements in the UK, which at their core relate to stewardship principles. The FRC acknowledges that the Code does set out standards that are higher than the UK regulatory requirements, and therefore signing up to the Code is voluntary.

This article sets out: (a) the background to the Code; (b) the current requirements UK firms are already subject to; (c) key changes from the 2012 edition of the code; and (d) a summary of the Code's principles and reporting expectations as applicable to those organisations who become Code signatories.

BACKGROUND TO THE CODE

The overall aim of the Code is to ensure the quality of stewardship is enhanced and exercised effectively in investments across a range of asset classes, in addition to UK listed equities such as fixed income bonds, real estate and infrastructure and to cover assets held by international investors in the UK.

Stewardship aims to protect consumers interests by aligning firms' incentives with the long-term interest of consumers of financial services and ensuring investment firms governance, culture and incentives promote the consumers best interest.

The current definition of 'stewardship' under the Code is defined as the *'responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.'* With stewardship activities including, amongst other, the following four main activities:

- investment decision-making;
- monitoring assets and service providers;
- engaging with issuers, collaborating with others; and
- exercising rights and responsibilities.

Although voluntary, the importance of the Code is emphasised by the FCA's support of it. Ultimately, as a regulator of the financial services industry in the UK, one of the FCA's objectives is to ensure that the markets function well, decisions made by asset owners and asset managers improve market quality and integrity and ultimately help create sustainable long-term value for clients and beneficiaries. FCA takes the view that stewardship can help support market integrity and therefore look to encourage firms to comply with the principles set out by the Code, who play an important role in minimising systemic risks and ultimately being stewards of their investments.[1]

As a result, in order to avoid reinventing the wheel, it makes sense for the financial services industry to be able to rely on a pre-existing structure focused on stewardship matters, which has been updated to remain applicable to the industry as it stands today, 7 years after the first iteration of the Code.

With appreciation of the fact that players within the financial services industry differ by size, type and business model, the Code aims to offer a more flexible approach to setting stewardship practices by enabling firms to assess which reporting expectations of the Code are relevant and appropriate to their business.

UK REGULATORY REQUIREMENTS

[1] In October 2019, the FCA published a Feedback Statement FS19/7 (the "**Feedback Statement**") in response to their Discussion Paper - Building a Regulatory Framework for Stewardship ("**DP19/1**").

Despite the Code being a voluntary measure, it's clear that many organisations deem it an important framework which is reflected by the number of signatories to the 2012 edition of the Code. In relation to UK asset managers alone, over 160 firms signed up to the 2012 edition of the code.

Since December 2010, all asset managers authorised by the FCA have been required to produce a statement of commitment to the UK Stewardship Code or explain why it is not appropriate to their business model.[2]

Asset owners such as trustees of occupational pension schemes are required to develop and explain how they have implemented policies for the exercise of the rights and engagement for all investments, including how they monitor investee companies and their voting behaviour. They will also be required to explain how their equity investment strategy is consistent with their liabilities and provide information on their arrangements with asset managers.

Furthermore, the Pensions Regulator encourages adherence to the Code in its guidance for trustees of defined benefit and defined contribution schemes.

Service providers such as proxy advisors are required under the Proxy Advisors (Shareholders' Rights) Regulations 2019 (PA Regulations), supervised by the FCA, to publicly disclose a code of conduct and explain how they have followed it. Proxy advisors may wish to use the Principles for Service Providers as their code of conduct. They are also required to disclose and implement a conflicts of interest policy and give assurance about the accuracy and reliability of their advice.

KEY CHANGES TO THE CODE

The key changes and additions to the Code in comparison to the 2012 edition include:

- **more principles being introduced:** the 2012 edition of the code consisted of 7 principles whereas the Code now consists of 12 principles for asset managers and asset owners and 6 principles for service providers;
- **separation of principles for (a) asset managers and asset owners; and (b) services providers:** by moving away from a single approach the aim is to create more effective stewardship by allowing firms to meet the Code's expectations in a way that is better aligned with their business and strategy;
- **more onerous reporting expectations:** signatories to the Code are expected to report annually on against stewardship activity and outcomes. An annual stewardship report must be produced to show what has been done in the previous year and the outcome;
- **increased focus on purpose, strategy and investment beliefs and culture support stewardship:** signatories to the Code must explain their firm's purpose, investment beliefs, strategy and culture and explain how these enable a firm to practice stewardship;
- **increased scope of asset classes and application:** signatories to the Code are now expected to explain how they have exercised stewardship across asset classes beyond listed equities, such as fixed income, private equities and infrastructure, and in investments outside the UK; and
- **consideration of environmental, social and governance factors** ("**ESG**")**:** signatories to the Code are expected to take ESG factors (including climate change) into account and to ensure their investment decisions are aligned with the needs of their clients ,because in recent years this has become an important consideration for investors to consider when making investment decisions.

PRINCIPLES AND REPORTING EXPECTATIONS

[2] Per COBS 2.2.3 and COBS 2.2A.5

Each principle is supported by reporting expectations which the FRC expects firms to include in their stewardship report, utilising the 'apply and explain' approach, in order to become and remain a signatory to the Code.

The principles applicable to asset managers and asset owners can be split into 4 broad categories:

1. Purpose and governance: principles 1–5.

Apply:	Explain:
1. Take actions to ensure investment beliefs (i.e. factors considered important for their desired investment outcomes), strategy, culture, business model and strategy enable effective stewardship.	How investment beliefs have guided stewardship, investment strategy and decision making, and ultimately how effective the firm has been in serving the best interest of clients.
2. Put in place effective governance structures and processes to enable oversight and accountability for effective stewardship.	What governance structures and processes are in place, how stewardship activities have been resourced internally and externally outsourced to service providers, and if they have implemented and performance or reward programmes to incentivise employees in integrating stewardship.
3. Ensure their conflicts of interest policy identify and manage actual/potential conflicts related to stewardship to put the best interests of clients first.	How firms have addressed actual/potential conflicts of interest and how this is disclosed in their policies.
4. Identify and respond to market-wide and systemic risks in order to promote the improved functioning of financial markets and align their investments accordingly.	How they have assessed market wide risks and the appropriate response e.g. by working with other stakeholders, participating in industry initiatives.
5. Review policies to ensure they enable and facilitate effective stewardship.	How their review has led to regular and continuous improvements of stewardship related policies and processes whether that be assurance received internally or externally.

2. Investment approach: principles 6-8.

Apply:	Explain:
6. Take into account client needs and communicate any stewardship and investment related activities and outcomes to them.	What information has been communicated to clients about their stewardship and investment activities, and where and why assets haven't been managed in alignment with their client's stewardship and investment policies.

7. Disclose any issues prioritised for assessing investments including any ESG issues of importance.	How information gathered through stewardship has informed acquisition, monitoring and exit decisions, how they've ensured the requirement to integrate stewardship and ESG issues throughout the process and how that has best served clients.
8. Monitor service providers to ensure services delivered to meet the signatories' needs.	How they have monitored services provides and/or any actions taken when expectations from managers/services providers haven't been met.

3. Engagement: principles 9-11.

Apply:	Explain:
9. Engage with issuers to maintain or enhance the value of assets.	How objectives for engagement have been developed, what methods of engagement used and how that has been implemented and prioritised and how outcomes of engagement have informed investment decisions.
10. Participate in collaborative engagement to influence issuers.	How they have participated in collaborative engagements with other investors and issuers, and the outcomes of such engagements.
11. Escalate stewardship activities to influence issuers.	How they select and prioritise issues for escalation, approach in escalating and how the outcomes of escalation informed investment decisions.

4. Exercising rights and responsibilities: principle 12.

Apply:	Explain:
12. Actively exercise their rights and responsibilities in respect of listed equity and fixed income investments.	What expectations are set for asset managers that may exercise rights and responsibilities on their behalf, any relevant voting policy, use of proxy advisors, how shares and voting rights are monitored and any relevant approaches to seeking amendments to relevant terms and conditions or other investment documents.

The 6 principles applicable to service providers, and their respective apply and explain approaches are as follows:

Apply:	Explain:
1. Ensure their strategy and culture enable them to promote effective stewardship.	The purpose of the organisation, the services it offers and outline its cultures, values, business model and strategy to enable them to promote effective stewardship and how effective that has been in serving the best interests of clients.
2. Put in place effective governance structures and processes to enable oversight and accountability for effective stewardship.	How their services have promoted effective stewardship, how stewardship has been resourced internally, how their fees are appropriate for the services provided and how the governance structures/processes implemented to support clients stewardship may be improved.
3. Similar to principle 3 above.	Similar to principle 3 above.
4. Similar to principle 4 above.	Similar to principle 4 above.
5. Support clients' integration of stewardship and investment, taking into account ESG issues	How their services best support clients, whether they have sought client feedback, methods and frequency of communication with clients and how they have taken that information into consideration to understand client needs and value effectiveness of their service.
6. similar to principle 5 above	Similar to principle 5 above.

NEXT STEPS

As mentioned above, becoming a signatory to the Code is voluntary and therefore not all firms will wish to sign up and comply with the Code's reporting requirements. In such cases, firms will need to carefully consider how they can effectively comply with their regulatory requirements and in any event the principles posed by the Code could set a useful framework to approach this. The FCA have noted that effective stewardship still has a way to go and therefore prescribed regulation in this area may be on the cards at some point, which would in any event complement existing measures such as the Code. Therefore, firms that don't take a conscious decision to familiarise themselves with the Code may end up on the back foot.

Firms should be aware that from 31 December 2019 the FRC will no longer accept statements against the 2012 edition of the Code. For organisations looking to be included in the first list of signatories, they must submit their final stewardship report to the FRC by 31 March 2021 after which the FRC will evaluate the stewardship reports and those who meet the reporting expectations will subsequently be listed as signatories to the Code. Please follow this link for access to the Code.

For more information, and any guidance or advice on your obligations under the Code and Stewardship generally, Cleveland & Co external in-house counsel™, your specialist outsourced legal team, are here to help.

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