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| asset management group

March 27, 2019

By Email: **cp19-07@fca.org.uk; dp19-01@fca.org.uk**

David Stubbs
Primary Markets Policy
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

Re: FCA Consultation Paper on Proposals to Improve Shareholder Engagement.

Dear Sirs:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide comments to the Financial Conduct Authority ("**FCA**") on the FCA's *Consultation on proposals to improve shareholder engagement* (the "**Consultation**"),[1] which sets out how parts of the Revised Shareholder Rights Directive (**"SRD II"**)[2] are proposed to be implemented in the UK.

The AMG is the voice for the buy side within the securities industry and broader financial markets, which services millions of individual and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. AMG's members comprise U.S., UK and multinational asset management firms with combined global assets under management exceeding $45 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS, and private funds such as hedge funds and private equity funds.

While our members operate both inside and outside the United States and many are considered to be global enterprises, the background and orientation of our organization is rooted in U.S. laws and regulations, and our letter reflects our familiarity with such laws and regulations.

[1] FCA Consultation Paper CP19/7, *Consultation on proposals to improve shareholder engagement* (January 2019), https://www.fca.org.uk/publication/consultation/cp19-07.pdf

[2] Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN

1. Scope of this letter

This comment letter primarily responds to the proposals within the Consultation regarding the requirements that would apply to asset managers and institutional investors. It does not address the proposed changes to the requirements for companies whose shares are admitted to trading on a regulated market in the UK.

We reference in places the concept of stewardship set out in the Proposed Revision to the UK Stewardship Code published by the Financial Reporting Council (**"FRC"**)[3] and discussed in the joint discussion paper published by the FCA and FRC, *Building a regulatory framework for effective stewardship* (**"Discussion Paper"**)[4], but we do not address the specific issues raised in the Discussion Paper.[5]

2. Approach to shareholder engagement

We recognise the importance of stewardship and initiatives to encourage shareholder engagement. In the asset management context, such initiatives must reflect the relationship between the asset manager, its client and any underlying beneficiaries. For a collective investment undertaking or separate account for an institutional investor, the asset manager will not be the legal or beneficial owner of the assets under management. The asset manager will act as agent for its client, which has a number of consequences in the context of shareholder engagement:

- Firstly, the ability of an asset manager to partake in shareholder engagement activities, particularly exercising voting rights in investee companies, is determined by the authority of and power granted to the asset manager under the agreement appointing the asset manager. For instance, investment management agreements with institutional clients will often include express provision regarding the exercise of voting rights, such as whether voting rights may be exercised by the asset manager in its discretion or upon receipt of instructions from the client.

- Secondly, the asset manager's shareholder engagement activities must be within the scope of and for the purposes of furthering its mandate under the terms of appointment of the asset manager, particularly the investment objective and policy. Where the asset manager's mandate provides for or envisages active shareholder engagement, then the asset manager will be obliged to partake in such activities. In the absence of express provision regarding

[3] FRC consultation, *Proposed Revision to the UK Stewardship Code* (January 2019), https://www.frc.org.uk/consultation-list/2019/consulting-on-a-revised-uk-stewardship-code?viewmode=0

[4] FCA and Financial Reporting Council Discussion Paper DP19/1, *Building a regulatory framework for effective stewardship* (January 2019), https://www.fca.org.uk/publication/discussion/dp19-01.pdf

[5] For this reason, we are copying this response to stewardshipcode@frc.org.uk and dp19-01@fca.org.uk, as we believe the statement of the AMG's general position is relevant to the broader discussion of stewardship in the Discussion Paper and revisions to the UK Stewardship Code.

the asset manager's participation in shareholder engagement activities, the asset manager must be guided by and act in accordance with its mandate under the terms of appointment. This will generally be determined by the asset manager's assessment of what will maximize the value for its clients and the application of the asset manager's engagement policy. For the exercise of voting rights in investee companies, an asset manager may not always be able to make a clear determination that the exercise of voting rights for or against a resolution is necessary for the furtherance of the relevant investment objective and policy. It will be appreciated that where an asset manager determines that its mandate under the terms of appointment does not require a vote in favour of or against a particular resolution, the asset manager will generally be unable to establish a basis for taking affirmative action and therefore will abstain from exercising its voting rights.

In other words, when considering shareholder engagement and specifically the exercise of voting rights, an asset manager will only vote where it receives specific instructions from its client, or where it has discretion to exercise voting rights under the terms of appointment of the asset manager and those terms provide a clear basis as to how the asset manager should exercise such discretion.

3. Proposed definition of stewardship in the revised UK Stewardship Code

We have considered the proposed definition of stewardship in the revised UK Stewardship Code, and we believe this definition does not accommodate the approach an asset manager is required to take in relation to shareholder engagement, as described in section 2 above.

In the proposed revisions to the UK Stewardship Code, stewardship is defined 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."*[6]

Regarding the reference to creating *"sustainable value for beneficiaries, the economy and society"*, aside from circumstances where the asset manager is acting on the instruction of its client, unless expressly provided for in its mandate, an asset manager will not have a basis for exercising rights solely on account of general economic or societal considerations. An asset manager will almost certainly consider whether shareholder engagement on a particular issue will have an impact on value for clients and beneficiaries, but only because this will likely be required by the applicable investment objective and policy. We understand *"sustainable value"* to refer to a medium to long term horizon. In fact, whether the asset manager is required to consider the impact on clients and beneficiaries on a short, medium or long term horizon will depend on the relevant investment objective and policy.

[6] Financial Reporting Council, *Proposed Revision to the UK Stewardship Code* (January 2019, https://www.frc.org.uk/getattachment/bf27581f-c443-4365-ae0a-1487f1388a1b/Annex-A-Stewardship-Code-Jan-2019.pdf

Our concern is that the Consultation, in combination with the revisions to the UK Stewardship Code and the statement that stewardship is to be an area of focus for the FCA's supervisory engagement going forward[7], will create an expectation that asset managers ought to become activist shareholders. In relation to the exercise of voting rights, an asset manager should not be compelled to vote where it has no instructions or mandate to do so. Where an asset manager has a basis for voting, it must only do so in accordance with its clients' instructions or its mandate, which may or may not be consistent with the qualitative factors in the proposed definition of stewardship. Requiring asset managers to partake in shareholder engagement activities in other circumstances would not be appropriate. As stated in section 2, the assets and the rights attaching to them do not belong to the asset manager, either legally or beneficially. Consequently, any shareholder engagement should only be in accordance with the wishes of investors, whether by express instruction or implied by the mandate.

3. General comments on the Consultation

The AMG understands the FCA's objective of building a regulatory framework for effective stewardship. Furthermore, we recognise the underlying objectives of the Consultation, namely to encourage discretionary asset managers and institutional investors to *"take an active interest in the decisions made by the governance bodies of the issuers of the assets they invest it".*[8] However, it must be recognised that the changes made by SRD II and its implementing legislation and regulation, including the changes proposed in the Consultation, will not change by themselves the factors noted in section 2 that determine whether an asset manager has the authority and mandate to partake in shareholder engagement activities.[9] There is a risk that over prescription could have a chilling effect on shareholder engagement, and that stewardship becomes a compliance exercise without any substantive change to the oversight of the governance of investee companies. Beyond these general concerns, we have noted below certain aspects of the proposals within the Consultation that could raise significant issues for AMG members.

4. Territorial scope (i.e. application to investee companies listed on non-EEA markets)

Consultation Q1: Do you agree that the territorial scope of the rules framework should extend beyond that envisaged by the Directive?

The provisions of SRD II relating to shareholder engagement by asset managers and institutional investors apply in respect of shares traded on a regulated market.[10] The proposal in the Consultation to extend the scope of the UK rules implementing SRD II to investee companies whose shares are

[7] Consultation, paragraph 2.7

[8] Consultation, paragraph 2.7

[9] Consultation, paragraph 2.7

[10] Article 1 (1)(a) of SRD II

admitted to trading *"on a comparable market outside the EEA"*[11] could have adverse consequences and create an unlevel playing field for UK asset managers, which would be contrary to the FCA's stated intentions.[12] The AMG acknowledges the FCA's observation that *"consumers of UK asset management services could reasonably expect that UK asset managers would consider their approach to stewardship across all their investments in shares"*.[13] Whilst that may be the case, we would have a number of concerns if the provisions implemented in the UK would apply to a broader range of investee companies than under equivalent provisions in other jurisdictions, including the following:

- The requirements applicable in the EEA would not be harmonized. This would have a number of consequences: (i) A UK asset manager will be subject to requirements that are more onerous than those applicable to asset managers in other EEA states, which may result in a competitive disadvantage. (ii) For multinational asset managers, having different regimes in different jurisdictions hinders the ability to introduce global or Europe-wide policies and procedures, and increases the cost and complexity of compliance. (iii) From the perspective of investors, the different requirements will impact the comparability of disclosures.

- Investee companies whose shares are not traded on a regulated market would not be subject to the provisions under the SRD II and the implementing regulation.[14] Investee companies traded on comparable markets may not be subject to a regulatory framework that facilitates the exercise of shareholder rights.

The AMG's view is that the rules incorporating the provisions of the SRD II into the UK should have the same scope as provided for under the SRD II itself. Some of our members may implement engagement policies and make disclosures that include investee companies traded on comparable markets outside the EEA, however this ought to be a matter for each manager to decide independently, taking into account the requirements of its particular clients and its global policies and procedures. Accordingly, our view is that the requirements implemented in the UK should apply in relation to investee companies whose shares are traded on an EEA regulated market.

[11] Definition of 'regulated market' (as amended by Consultation)

[12] Paragraph 3.3 of Consultation

[13] Paragraph 3.8 of Consultation

[14] Including Commission Implementing Regulation (EU) 2018/1212 of 3 September 2018 laying down minimum requirements implementing the provisions of SRD II, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1212

5. Requirements regarding engagement policy and annual disclosure of implementation of engagement policy

Consultation Q2: Do you agree with our proposed amendments to the Handbook to implement the Directive requirements around engagement policies? If not, please explain what alternative approach you would like us to take.

The AMG recognises the importance of initiatives to improve investors' understanding of shareholder engagement and the corresponding responsibilities of asset managers and institutional investors. Regarding the proposed FCA rules requiring the development and publication of an engagement policy and publication of an annual disclosure in respect of compliance with such policy, the AMG supports the FCA's proposal to copy-out the provision of SRD II without further modification or explanation, subject to the following points:

- Our members believe the lack of prescriptive requirements around engagement policies is important. Specifically, it is important that the rules are sufficiently flexible to allow firms to refrain from publishing an engagement policy in particular circumstances (for example, if the asset manager's strategies do not involve the acquisition of relevant shares), and to determine the level of detail with which to address each of the minimum prescribed contents[15]. The AMG agrees that such flexibility should apply on a 'comply or explain' basis. The AMG further agrees that there should be flexibility to allow an asset manager or institutional investor to decide how to design such policies and annual disclosures, such as whether to disclose on a complex-wide basis, or along product, strategy or portfolio management team lines.

- A number of the prescribed contents for engagement policies envisage asset managers and/or institutional investors interacting with other investors in an investee company. This includes the requirement for engagement policies to describe *"how the firm … cooperates with other shareholders"* and *"communicates with relevant stakeholders of the investee companies"*.[16] We would hope that their inclusion in the list of prescribed contents for engagement policies is not an indication that the FCA expects asset managers to engage more actively in shareholder cooperation and communicating with relevant stakeholders of investee companies.

  There are multiple considerations that may affect whether such cooperation or communication is appropriate. For example: (i) Cooperation with another shareholder or asset manager may result in those persons being deemed to be 'acting in concert'. A number of regulatory requirements use this or a similar concept. For example, under The Takeover

[15] Rule 2.2B.6 R of the Conduct of Business Sourcebook ("**COBS**") (as proposed in Consultation)

[16] COBS 2.2 B.6 R (as proposed in Consultation)

Code[17] persons acting in concert are required to aggregate their shareholdings for the purposes of determining whether relevant thresholds have been reached (for example, in relation to the making of mandatory bids), and aggregation may also be required for substantial shareholder filings. (ii) Cooperation and/or communication between shareholders may raise competition law concerns. (iii) Information regarding other shareholders' views on an issue and their intention to vote may amount to market sensitive information.

We believe that encouraging cooperation with other shareholders and/or communication with an investee company's stakeholders without fully setting out the relevant legal and regulatory constraints on such activities may result in practices which are inconsistent with the constraints noted above.

- For the annual disclosure of how a firm has implemented its engagement policy, we note that: (i) there is a requirement for an explanation to be provided *"of the most significant votes"*.[18] and (ii) the requirement to disclose voting behaviour excludes *"votes that are insignificant due to the subject matter of the vote or the size of the holding company"*.[19] We further note that the proposed provisions in the Consultation do not include any guidance on when a vote may be considered *"most significant"* or *"insignificant"*.

  Recital 18 of SRD II provides some examples of insignificant votes, such as votes on purely procedural matters. The link between the requirement to disclose voting behaviour other than for such insignificant votes and the idea that stewardship, as defined in the revised UK Stewardship Code, includes *"holding [issuers] to account on material issues"*, is not apparent. This appears to be one aspect of the changes that will be more of a compliance exercise rather than a stewardship one.

  The AMG agrees that the question of significance and insignificance should be for firms to decide based on the factors they determine to be relevant. Whether or not a vote is deemed to be significant or insignificant may vary for different managers.

[17] As defined in The Takeover Code published by The Panel on Takeovers and Mergers

[18] COBS 2.2B.7 R (1) (as proposed in Consultation)

[19] COBS 2.2B.7 R (2)(b) (as proposed in Consultation)

6. Transparency requirement for asset managers (i.e. required disclosures by asset managers to institutional investors)

Consultation Q4: Do you agree with our proposed amendments to implement the Directive requirements on asset managers reporting to asset owners? If not, please explain what alternative approach you would like us to take.

As mentioned above, whilst the AMG recognises the importance of stewardship and initiatives to encourage shareholder engagement, shareholder engagement must be in accordance with the wishes of the client and/or underlying beneficiary, and therefore driven by their needs and requirements. As such, the AMG does not support the imposition of prescriptive requirements for the disclosure of information by asset managers to institutional investors, although we recognise that since these requirements are set out in SRD II, there are limited options for deviating from them in the UK implementation. However, we would raise the following points on the proposed amendments to implement SRD II in the UK:

- The substance of what is required to be disclosed is not clear in the draft rule set out in the Consultation. The proposed rule 2.2B.9 R (2) of the Conduct of Business Sourcebook would require disclosure of how a manager *"complies with the arrangement referred to in (1);"*. As currently drafted; the cross-reference to sub-paragraph (1)[20] refers only to the type of client to whom disclosure must be provided and not to the *"arrangement"* in respect of which compliance is required.

- In contrast to the transparency requirements for institutional investors (discussed in section 8 below), these disclosure requirements do not appear to apply on a 'comply or explain' basis. The AMG believes there should be flexibility regarding these disclosures, and expects there may be instances where it would not be appropriate to provide such disclosure. As such, the AMG proposes that these requirements should apply on a comply or explain basis.

- If a manager chooses to make such information available publicly to all investors, the AMG agrees with the FCA's intention that this should relieve a firm of the need to provide the disclosure directly to an SRD institutional investor.[21] However, the rules seem to indicate that the disclosure must be specific to the relevant SRD institutional investor.[22] It is therefore unclear whether this disclosure is capable of being provided in a generic format. The AMG believes further guidance regarding the content and purpose of this disclosure is required, including clarification as to whether such disclosures may be generic or are required to be client specific.

[20] COBS 2.2B.9 R (1) (as proposed in Consultation)

[21] Paragraph 3.39 of Consultation; COBS 2.2B.10 G (as proposed in Consultation)

[22] In particular, COBS 2.2B.9 R (2) (as proposed in Consultation)

- We would request confirmation that if disclosure is already provided separately, an additional disclosure for SRD II purposes would not be required. For example, we expect *"turnover and turnover costs"* to be covered by MiFID II reporting on transaction costs. If the FCA is expecting firms to take a different approach, or interprets *"turnover and turnover costs"* to mean something else, please could this be confirmed.

- Since this disclosure requirement will apply to investments in collective investment undertakings by institutional investors, if the investors in a collective investment undertaking include both "SRD institutional investors" and other investors (which is likely for a UCITS fund), then different investors will receive different information. Selective disclosure is not appropriate for a UCITS fund, and there is a risk of inadvertently requiring overcomplicated communications to be sent to retail clients.

- Regarding the FCA's request for feedback on whether in practice it is easier for managers to include disclosures in a fund's annual report, this would appear superficially beneficial to avoid different investors receiving different information. On the other hand, it would not necessarily result in investors receiving the information they require, nor would it decrease the burden on asset managers. Institutional investors that are actively interested in shareholder engagement will often request bespoke information, which would not be satisfied by a generic disclosure in an annual report. Consequently, we would not recommend requiring disclosure in annual reports, but where an asset manager chooses to do so, it should be clear that this satisfies the disclosure requirement.

7. Transparency requirement for institutional investors (i.e. required disclosures by life insurers to investors)

Consultation Q3: Do you agree with our proposed approach to implementing article 3h of the Directive? If not, please explain what alternative approach you would like us to take?

Our comments on the requirement for life insurers to publicly disclose the information set out at the proposed rule 3.4.9 R (1) of the Senior Management, Systems and Controls Sourcebook ("**SYSC**") are principally made from the perspective of asset managers that may be appointed by a life insurer to provide investment management services.

We are concerned that the disclosure requirements may compel the disclosure of information that is more extensive than necessary and that is commercially sensitive. This is a particular concern regarding the disclosure requirements relating to the incentives for the manager and the methodology for evaluating a manager's performance and remuneration. Although investment management agreements will often include confidentiality provisions, these will typically include an exclusion from the duty to maintain confidentiality where disclosure is required by applicable law or regulation. Although the obligation applies on a 'comply or explain' basis, this is at the determination of the life insurer and not the manager. Disclosure requirements should be proportionate to the benefits they bring to investors and should take into account the potential for unanticipated consequences from public disclosure of detailed information. The AMG would

welcome clarification in the proposed rules that the disclosure requirement at SYSC 3.4.9 R (1) would not require life insurers to publicly disclose information that is of a confidential nature.

8. Timing

The AMG welcomes the indication in the Consultation that if our members are unable to update their engagement policies in advance of the application date of 10 June 2019, it will be possible for them to indicate on their website what they are doing to develop an engagement policy.[23]

SIFMA AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the FCA might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 or tcameron@sifma.org or Lindsey Keljo at 202-962-7312 or lkeljo@sifma.org with any questions.

Sincerely,

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Asset Management Group – Head
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[23] Paragraph 3.27 of Consultation.