

# KIRKLAND & ELLIS

Kirkland Alert

## What Asset Managers Need to Know About the Shareholder Rights Directive II

17 June 2019

### What is the Shareholder Rights Directive (SRD I)?

SRD I was implemented in 2009 to enhance the rights of shareholders by imposing certain minimum standards on the exercise of voting rights attaching to shares in a company that has a registered office in the European Union ("EU") and is listed on EU regulated markets (each such company, an "EU Listed Company"). SRD I has been substantially amended by the [Revised Shareholder Rights Directive](#) ("SRD II"), which came into force on 10 June 2019.

### New proposals under SRD II

SRD II amends SRD I primarily with the objective of increasing long-term focus in corporate governance and to address perceived shortcomings related to: (i) short-termism in the investment universe; (ii) insufficient oversight on directors' pay; (iii) insufficient oversight of related party transactions; and (iv) the interaction between companies and shareholders being ineffective in cross-border situations. SRD II applies to asset managers and institutional investors, and imposes certain disclosure requirements on their engagement as investors in EU Listed Companies.

It is important to note that SRD I and SRD II will *not* be relevant to investments in privately held EU companies.

### How is the UK implementing SRD II?

On 31 May 2019, the UK Financial Conduct Authority ("FCA") published a policy statement containing the final rules implementing SRD II, which took effect on 10 June 2019. However, the FCA has indicated that, because the rules will come into effect quickly after publication, for an initial period after 10 June 2019 a firm may be able to comply with the SRD II requirements by explaining what it is doing to develop a shareholder engagement policy. The FCA has not clarified how long this "initial period" would be.

## Who is caught by SRD II?

### 1. In-scope companies

EU Listed Companies are in scope. If an EU Listed Company has its registered office in one Member State and is admitted to trading on an EU regulated market in another Member State, it is the law of the Member State of the EU Listed Company's registered office that regulates matters covered in SRD II.

Accordingly, the following companies are *outside* the scope of SRD II:

- companies incorporated outside the EU with shares admitted to trading on an EU regulated market; and
- companies incorporated in a Member State with shares listed on a market that is not an EU regulated market.

The FCA intends to gold-plate the provisions so that the provisions described in further detail below apply to shares in all companies admitted to trading on an EU regulated market or on a *comparable market outside of the EU*. The FCA had opposition to this extension during its consultation period from the investment community on the basis that this approach would impose a disproportionate burden on UK firms (compared with firms in other EU jurisdictions). However, the FCA has noted that on balance, they believe that consumers of UK asset management services should reasonably expect UK asset managers to consider and disclose their approach to stewardship across all their investments in shares.

### 2. In-scope institutional investors and asset managers

The provisions of SRD II that are relevant to institutional investors and asset managers apply to:

- *EU institutional investors:* SRD II defines institutional investors as EU life insurers and reinsurers and pension funds; and
- *Asset managers:* SRD II defines "asset manager" as a Markets in Financial Instruments Directive ("MiFID") investment firm that provides portfolio management services to investors, an Undertaking for Collective Investment in Transferable Securities Directive ("UCITS") management company, a UCITS fund without an external management company and an Alternative Investment Fund Manager ("AIFM") (as defined in the Alternative Investment Fund Managers Directive) excluding a sub-threshold AIFM.

As drafted, it is not clear if the obligations on "asset managers" apply to non-EEA AIFMs. However, as a practical matter it is difficult to see how the rules could apply to such non-EEA AIFMs as there would appear to be no "competent Member State" for such entities under Article 1 of SRD II. The UK rules are clear that they only apply to UK authorised AIFMs.

It is also not clear whether it is intended that the definition of "asset manager" carve out MiFID firms who are "investment advisers" on the basis that they do not provide *portfolio management* services to investors.

## What are the key new obligations on asset managers under SRD II?

SRD II introduces enhanced transparency requirements for asset managers and institutional investors in relation to shareholder engagement. Below are the key provisions relevant to asset managers.

### **Engagement Policy**

Under SRD II, asset managers must develop and disclose on a "comply or explain" basis, a policy on how they exercise voting rights and engage as shareholders in EU Listed Companies ("Engagement Policy").

The Engagement Policy must be made available free of charge on the asset manager's website and should address how the asset manager:

- monitors investee companies;

- interacts and cooperates with shareholders; and
- manages conflicts of interest with investee companies.

## Annual disclosure

An asset manager must disclose (on a "comply or explain" basis) annually:

- how the Engagement Policy has been implemented, including a general description of voting behaviour and the use of the services of proxy advisors; and
- how the asset manager has cast votes in the general meetings of EU Listed Companies in which it holds shares.

## Institutional investor disclosures regarding asset managers

Where an asset manager invests on behalf of EU institutional investors (either through segregated mandates or through pooled funds), certain additional disclosure requirements apply to the EU institutional investor. The EU institutional investor must disclose on its website:

- how the asset manager is incentivised to align its investment strategy with the profile and duration of the liabilities of the EU institutional investor, in particular long-term liabilities;
- how the asset manager is incentivised to make investment decisions on medium to long-term performance of the EU Listed Company and to engage with the EU Listed Company in order to improve its performance;
- how the method and time horizon of the asset manager's performance and remuneration align with the profile and duration of the liabilities of the EU institutional investor;
- how the EU institutional investor monitors portfolio turnover costs incurred by the asset manager; and
- the duration of the arrangement with the asset manager.

The above disclosures need to be publicised on the EU institutional investor's website and updated annually unless there has been a material change. Although it is not expressly set out in SRD II, we would expect that an update would be required at the time of the material change.

In the UK, the FCA have clarified that the disclosures are not expected to contain commercially sensitive information and asset managers ought to be able to provide high-level information about the matters listed above. It is our expectation that that

other Member States will take this view.

However, note that the FCA will require UK institutional investors to make these disclosures in respect of asset managers regardless of whether those asset managers are based in the EU or outside of the EU.

As a result of these obligations, we may expect EU institutional investors to request side letter provisions stating that they are permitted to make certain public disclosures regarding their investments in a fund in order to comply with these obligations.

#### Asset manager disclosures

On an annual basis, asset managers are required to disclose to EU institutional investors information about:

- how the asset manager's investment strategy complies with the arrangements entered into with such institutional investors; and
- how that strategy contributes to the medium to long-term performance of the assets of the institutional investors or of the funds.

An AIFM may make these disclosures as a part of its annual report to investors required under the AIFMD. Note that Member States may require that AIFMs make these disclosures to other investors in a fund (i.e., investors that are not EU institutional investors). Asset managers may want to make the disclosures available to all investors nonetheless to ensure fair treatment of investors. The FCA is proposing not to do this.

## How does the UK implementation relate to the UK Stewardship Code?

In January 2019, the FCA and the Financial Reporting Council ("FRC") issued proposals to revise the existing UK Stewardship Code (published in 2010 and updated in 2012) relating to stewardship in the institutional investment community ("Stewardship Code"). These proposals must be read in the context of the final rules on SRD II published by the FCA as the revised proposals on the Stewardship Code builds on SRD II and could be extended further.

At present, the Stewardship Code applies to collective portfolio management firms carrying on MiFID activities (e.g. portfolio management). Such firms who manage investments for professional investors are already required to disclose the nature of their commitment to the Stewardship Code or disclose their alternative investment strategy.

Some of the key changes to the Stewardship Code proposed by the FRC are:

- amending the definition of “stewardship” to make it clear that it is focussed on firms looking after the assets of beneficiaries that have been entrusted to their care and broadening the scope of the code to include investment decision-making and investment in assets other than listed equity;
- setting higher standards for how stewardship responsibilities are integrated in investment processes;
- recognising the importance of environmental, social and governance issues; and
- imposing more rigorous reporting requirements.

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## Related Services

### Practices

- [Transactional](#)
- [Investment Funds](#)

## Suggested Reading

- [17 June 2019 Press Release Kirkland Represents Resonetics in Equity Investment in Medibrane](#)
- [14 June 2019 Award Chambers USA Texas Awards 2019](#)
- [14 June 2019 Award Most Influential Private Equity Investors & Advisors 2019](#)