Shareholder Rights Directive

This regulatory update is for audit leaders across all sectors, not just financial services.

The Shareholder Rights Directive II marks a step change in governance. It is not only a regulatory compliance issue but one of transparency and accountability that all organisations need to uphold.

In response to corporate failures, it is about enhancing stewardship.

Audit leaders need to be aware of how this impacts their organisation:

- Financial Services - compliance risk, operational impact on activities of asset owners/ managers
- Private Sector - strategic risk, corporate governance impact, ability to attract investors
- Charities - reputation risk through investment association and lack of stewardship activity
- Public Sector - reputation risk through investment association and lack of stewardship activity

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Background

The Shareholder Rights Directive (SRD)II has been effective since June 2019.

The previous version was revised by the EU following learnings from the financial crisis to encourage more effective stewardship and long-term investment decision-making. The UK has been progressive in its approach to stewardship and many elements are already common practice in the UK. The revisions also took into account the 2018 Kingman Review.

The FCA produced rules, PS19/13, to ensure compliance SRD II.

Why was the change necessary?

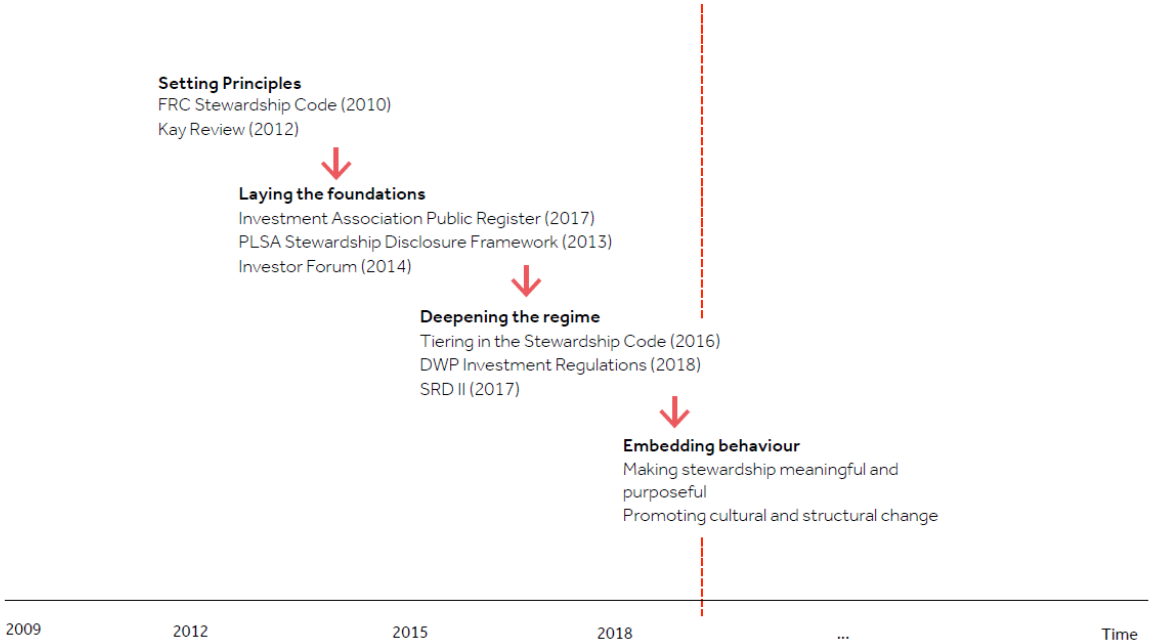
The stewardship role of investors in good corporate governance has increased in importance following numerous corporate failures. The pursuit of profit at any cost is no longer tolerated.

Speaking in March 2019, Edwin Schooling Latter of the FCA, attributed the "*unprecedented interest in stewardship*" to the concern "*in howcompanies and investment firms manage environmental, social and governance risks*."

SRD II builds on existing good practices, aiming to address issues such as:

- Excessive/Unjustified pay, the misalignment of reward and performance
- Short-termism, pressure to produce results that risk long-term performance/sustainability
- Impeded decisions, poor engagement by shareholders fails to support good decision-making
- Strategic clarity, investors have not been transparent about their strategies and policies

Listed companies are owned by their shareholders and operated by their directors. The historic *silent partner* approach has been significantly overturned since the financial crisis of 2008. It is a journey and SRD II represents the next phase of the stewardship journey as shown in the diagram below.



Source: FCA Building a regulatory framework for effective stewardship

Effective stewardship requires being invested in the values by which the organisation operates not simply the value it creates. Consideration of all stakeholders is paramount to ensuring sustainability.

The UK already has strong representation with the Investment Association reporting a 31% increase in shareholder 'revolts' in the first half of 2018 which amounted to 237 instances of dissent; common issues include remuneration, diversity and board composition.

How might this journey impact audit leaders?

- What could/should shareholders expect of internal audit in the future?
- Should shareholders have the right to request assurance from internal audit?
- Will shareholders want a direct relationship with the chief audit executive?

The rules

SRD II is on a comply-or-explain basis. They apply to regulated life insurers, asset managers, and companies with shares admitted to trading on a regulated market, all of whom will be directly affected by these proposals.

Stakeholders, particularly consumers and retail investors should also be aware of these requirements; audit leaders take note.

In summary there is a requirement for:

- institutional issuers, such as asset managers, pension funds and insurance companies to develop and publicly disclose their engagement policy towards their shareholders

- easier exercising of shareholders rights, including cross-border voting; better sharing of information throughout the investment chain with intermediaries passing relevant information from the issuer on to shareholders, and vice versa
- transparency in the voting process is also addressed, including where the services of a third party, such as proxy advisors or an investee company, are used
- certain asset managers (including those acting for pension schemes) to disclose information on their investment strategies.
- introduces a new related party transaction regime that runs in parallel to the existing related party regime in Chapter 11 of the Listing Rules.
- requires listed companies to publish a remuneration policy and to give shareholders a vote on the remuneration policy. Member States can decide whether this should be a binding vote or an advisory one only. This is already a binding vote in the UK and remains so.

For full details see PS19/13.

Additionally, Thomson Reuters provides a concise guide on the transition of EU regulations, including the corporate governance rules in the Disclosure Guidance and Transparency Rules and Listing Rules.

FCA authorised asset managers are not strictly required under the FCA rules to comply with the Stewardship Code although they are generally required to disclose whether or not they do so.

Thoughts for audit leaders

There are obvious implementation/compliance requirements within financial services. Aside from this practical assurance, there is also an opportunity for internal audit in all sectors to engage with governance leaders.

SRD II aims to promote long-term company sustainability in financial and non-financial performance measures. The intention is that this will benefit all stakeholders, including shareholders and investors, with sustained returns and reduced risk.

1. Investor relations has traditionally been a function of finance, the CFO and/or dedicated Investor Relation teams. How inclusive is the process of non-financial relationships that enhanced stewardship requirements? What assurances do the board need that the company remains protected?
2. How significant is this to your organisation? Are there limited investors/shareholders or a plethora that meet the requirements? As audit leaders it is important to be aware of the potential implications and risk factors.
3. Is there a future scenario where audit leaders meet with key investors? Would this compromise or enhance independence? How/will the composition of the audit committee change to promote effective corporate governance?
4. Good shareholder stewardship may lead to uncomfortable questions and a level of data transparency not currently in place. What is the process for handling requests that are not covered by the published investor pack? What training is in place to ensure that the right balance is struck between openness and commercial sensitivity?
5. The long-term focus of SRD II may raise the profile of the viability statement that companies are

required to include in their annual report. What assurances do internal audit provide on the methodology and stress testing? Does the organisation make a robust statement or token compliance?

6. How are investor/shareholder risks managed? Do any exert undue pressure? What could assurance look like? Is this something that sits within the 'strategic' audit category? The supermarket Morrisons is an example of high-profile revolts, firstly in 2005 over their board composition and latterly in 2015 and 2017 over remuneration packages.
7. The activities of the remuneration committee are high profile. What role should internal audit have? What assurances should be boilerplate in the new era of good governance?
8. Should significant investors have the right to request assurance from internal audit? Perhaps this is a conversation point with your audit committee chair? Do they facilitate this already? How could it work?
9. What changes within your own organisation's investor/shareholder community do the audit committee/board expect to see in the near future? What could investors expect of internal audit in the future?
10. Are you satisfied with the level of governance assurance you provide to the board? Should there be more in the plan? Could it be the platform for a good discussion with the audit committee about the wider role of internal audit?

Closing Thoughts

Stewardship is at the heart of SRDII. It is about taking care of something on behalf of another. Shareholders, directors, audit leaders are all temporary in the lifecycle of their organisation.

Audit leaders have a responsibility to work in partnership with other governance leaders to enable good stewardship; to break down the barriers and encourage transparency. The improved decision-making will benefit the long-term future of the organisation and the world in which it operates.

When the time comes to pass the baton on to the next audit leader - will you have done your best?

You cannot escape the responsibility of tomorrow by evading it today

Abraham Lincoln

Additional reading

FCA – Shareholder Rights Directive II Policy Statement PS19/13