ADVICE TO ESMA

Survey on undue short-term pressure on corporations from the financial sector (ESMA30-22-620)

I. Executive summary

1. As the ESMA stakeholder group, the SMSG is not in a position to provide evidence on the areas of interest for ESMA which relate to specific market participants. However, the SMSG wishes to provide high-level feedback on certain aspects of the call for evidence. The SMSG has therefore analysed the areas selected in the call for evidence in respect of their relevance to short-termism. It has also provided a number of missing topics relevant to the issue of short-termism.

2. The SMSG supports the collection of data and opinions of market participants on short-term pressure on corporations as part of the EC's sustainable finance action plan. The SMSG agrees that a long-term management approach to corporate governance is a precondition for the adaptation of business practices towards a more sustainable growth path. This is essential in order to support the goals set out in the Commission action plan.

3. The SMSG has been requested to give advice on the survey on short notice and within a **very short time** frame of five weeks during the holiday season. The recipients of this comprehensive survey likewise are confronted with this unusually short period instead of the normal public consultation period of 9 weeks. The SMSG likes to point out that this raises **concerns** about the results of the survey being **sufficiently representative** to fulfil the mandate of the ESAs to collect **evidence** on the matter given by the EC.

4. The SMSG welcomes that ESMA explicitly notes that it is not claiming any causal link between the investigated areas and short-termism. It is important to avoid a preconceived view or bias, as a short-term horizon is not, per se, illegitimate: as mentioned in the call for advice, "The ESAs are expected to assess the extent to which short-termism is present and can be considered problematic". While ESMA mentions it's not claiming any causal link between the investigated areas and short-termism, it is important to avoid a preconceived view or bias.

5. **Short-termism should not be confused with financing operations with shorter duration**, such as short-term trading, liquidity management, treasury, trade credit and other financing of short duration. This would disregard the beneficial effects on market liquidity and the fact that institutional investors fulfil their fiduciary duties with a constant analysis of the asset's prospects and underlying performance. Opportunities-based investing and event-driven disinvesting contribute to long-term performance and are thus beneficial to investors and aligned with their long-term interests.

6. **Investment funds' recommended timeframe does not give an indication of incentives to short-termism**. Investment funds' recommended time periods rather indicate to potential investors

the timeframe corresponding to the characteristics of the asset class or risk profile of the fund they are about to invest in, thereby allowing the investor to act according to his or her given preference: the investment horizons of funds are specified in order for investors to be able to allocate their savings, capital or liquidities/ treasury according to their own respective time horizon. In summary the SMSG is of the opinion that an investment fund's recommended timeframe allows investors to make an informed decision and does not constitute a push towards a short-term preference, neither for the asset management company nor for the investors.

7. For retail clients, risk- and time-related behaviour depends on a series of very different factors; from this perspective, early economic and financial education, with, at a minimum, pan-European building blocks, would help individuals to be more familiar with the capital markets and comfortable making longer term investments.

8. For institutional clients the investment horizon and possibilities are very **dependent on their regulatory framework** (accounting, prudential, liquidity requirements). Investors and therefore asset managers could become more long-term oriented when the Capital Markets Union project will be completed and some key regulations could be amended in a positive way.

9. **CSR-Reporting** and ESG-factor considerations currently suffer from the **high level of uncertainty about the underlying concepts** and their diverse – soft and hard – legal framework. They also suffer from the **missing coherence of an ESG-related accounting framework**. This is strongly connected to a lack of agreed methodology in the overall assessment of ESG-performance and the respective **data quality**. Furthermore, it remains to be more closely analysed how sustainability results relate to long term value creation. SMSG members believe that these aspects pose a major challenge for the investing community to make valuable decisions and disclosures.

10. Extending the scope of **fair value accounting** to all (also new) financial instruments came with a **higher volatility of balance sheets and income statements** of in-scope companies compared to e.g. the historical cost accounting method. SMSG members believe this is one area that **needs further investigation in regard of short-termism incentives**. The EFRAG's IFRS 9 consultation is more than welcome and we would like to have seen more types of asset classes allowed (apart from equity and equity like) to benefit from long term accommodation in their accounting treatment.

11. The SMSG can't draw a straight line between short-termism incentives in financial markets and the use of derivatives or short selling by investment funds. Derivatives are instruments that permit to gain exposure to, or to hedge against, a market segment or risk. Regarding potential risks, the Regulation (EU) No 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps has already provided a regulatory response by banning naked short selling.

12. The survey does not reflect a number of important factors of short-term behavioural finance and digitalization of financial markets, as well as factors from the regulatory framework resulting in short-termism pressure. Machine conceived investment-strategies and their execution should not be designed with an undue short-term bias. The survey should also make a differentiation between engagement required by institutional investors as part of normal corporate governance and the role of activist investors. The latter may in some cases create short-term pressure on the management of a company. On the other hand, there are examples where they have had beneficial effects by addressing necessary and overdue changes. Further analysis of the impact of activist investors is warranted.

II. Background

13. On June 24 2019 ESMA published a call for evidence to collect information on undue short-term pressures stemming from the financial sector. This follows a mandate according to Action 10 of the Action Plan "Financing Sustainable Growth" (Fostering sustainable corporate governance and attenuating short-termism in capital markets)[1] under which the EC has invited the European Supervisory Authorities to each develop a report presenting evidence and possible advice on potential undue short-termism. The call is based on a definition of short-termism as "the focus on short-term horizons by both corporate managers and financial markets, prioritizing near-term shareholder interests over long-term growth of the firm".[2] The survey is part of the EC's analytical and consultative workstream in order to assess: (i) the possible **need to require corporate boards to develop and disclose a sustainability strategy**, including appropriate due diligence throughout the supply chain, and measurable sustainability targets; and (ii) the possible need to **clarify the rules according to which directors are expected to act in the company's long-term interest**.

14. ESMA has identified six areas which it considers relevant to examine in relation to the Commission's mandate. These areas are:

- Investment strategy and investment horizon
- Disclosure of Environmental, Social and Governance (ESG) factors and the contribution of such disclosure to long-term investment strategies
- The role of fair value in better investment decision-making
- Institutional investors' engagement
- Remuneration of fund managers and corporate executives
- Use of CDS by investment funds.

III. Advice

1. Definition and Notion of Short-termism

15. SMSG would consider it helpful if a clear definition of long-term investment and short-term investment would be introduced. The mere setting of a time frame – as done in question 7 – does not seem to sufficiently address the nature of an investment as long- or short-term.

16. While acknowledging this is part of the EC's mandate, the SMSG feels that the **description of short-term pressure as "undue" is questionable** under various aspects. We understand ESMA's mission is to identify evidence-based facts about the short-term nature of financial investments and the causes of investors' short-term orientation. This should imply a more neutral and less suggestive approach. In accordance with the European Commission's call for advice, the SMSG would consider it helpful if ESMA specified criteria to assess the extent to which short-termism can be considered problematic.

[1] COM(2018) 97 final.
[2] Definition according to second paragraph of section 1 of the Commission's mandate.

17. The group also sees a certain **inconsistency between the chosen focus of short-term pressure *from* the financial sector** and the questions included in the survey. These are mostly aimed at analyzing such practices ***within*** the financial sector, not potential effects of short-term pressure from the financial sector on others, eg on issuers and industry. It also stands in contrast to **the definition by the EC and as provided in the** explanatory **note** ("corporate managers prioritizing near-term shareholder interests over long-term growth of the firm"). This definition suggests that short-term pressure in general and therefore ***outside the financial sector*** is addressed under the relevant item of the Sustainable Finance AP.

18 The SMSG embraces the **clear distinction between undue near-term shareholder prioritization and the shareholder-value concept as such** since the sustainability debate often (and inaccurately) describes this as a fundamental hurdle toward stakeholder concerns and long-term value creation. Research suggests that short-term behaviour is more likely to favour interests of managerial agents of the firm than its owners (See eg Spießhofer, Responsible Enterprise (2017), S. 270 et seq.). In other words short-termism often can be seen as a result of unsolved conflicts of interests in the principal/agent relationship. Importantly there is no fundamental contradiction between shareholder-value orientation and sustainable corporate development.

2. Missing Aspects

19. The SMSG is concerned that the survey does not adequately cover innovation and financial digitalization. MiFID 2 specified the conditions that investment firms engaging in algorithmic trading, market making or high frequency trading should fulfill. These rules are aimed at preserving market integrity. In a similar manner and from an investment perspective it would be important to know about decision **criteria** and databases used by autonomous systems when making investment decisions, among others how data input and output is supervised. Automated investment decisions also raise concerns because of the **growing use of big data** analysis. Little is also known about the **algorithms** and this in the survey does not receive any attention. Without any preconceived view, the SMSG would welcome ESMA's further analysis in this field in order to understand the extent to which short-termism is present and can be considered problematic.

20. The survey also doesn't address whether certain **groups of activist** (not to be confused with active) investors may contribute to short-term pressure on target corporate entities (financial and non-financial alike). As a potential result unsustainable **dividends** may be granted, and **long-term investment necessary** to tackle upcoming technological changes and adaptions of business models **may be stalled**.

21. With its focus on traditional behavioural aspects the questionnaire misses the opportunity to create insight in how further factors can affect an investment strategy to become unduly short-term. Therefore it might be important to see the interaction between short-term financial behaviour and **changing technological, political and regulatory paradigms**. These factors provide important points of reference for investors, have led to significantly increased uncertainty and have therefore developed as short-term drivers (eg. soft or hard Brexit and timing, trade wars, Iran conflict, etc.)

22. The survey does not allow to gather structured feedback on short-termist activities that may be provoked by certain regulations. Some references to regulations and their impact on prevention of short-termism are included in the following paragraphs (see section 7 below and references to UCITS, and AIFM, as well as SRD II). These apply to the investors' side. It would however be advisable for ESMA to investigate and research into regulations aimed at issuers that may provoke short-termism in decisions of management boards of companies in a broader approach.

3. Investment Horizon and Investment Strategies (Section 2)

23. **Investors have different needs, risk tolerances, time horizons, and the recommended investment horizon is a useful piece of information (among others) helping to match the client needs with a type of investment.** To that end, investment funds offer a wide range of different risk profiles and time horizons. They **do not give an indication of incentives to short-termism as such**, they rather represent to potential investors the timeframe corresponding to the characteristics of the asset class or risk profile of the fund in order to meet different demands.

24. If there are short-term opportunities in the market, value can be created in the long term. On the other hand, asset managers are continuously assessed against market benchmarks, which challenges their ability to take a longer-term view and tolerate periods of underperformance by firms in which they may fundamentally believe.

25. For retail clients, the risk- and time-related savings behaviour is a complex area that investment advisers incorporate in their questionnaires aimed at understanding investors' objectives and in determining their clients' attitudes to risk / risk aversion, and their investment horizon. While the investment advisers' suitability and appropriateness assessment requirements are harmonized across Europe, the SMSG notes that the economic and financial education and accordingly the level of preliminary understanding and comfort of consumers towards long term financial instruments is different across the EU. **An early and continued financial and economic education plays a major role in enabling individuals to make adequate and informed decisions; on the other hand, a low level of understanding is likely to drive individuals to liquid short-term products, such as liquid saving deposits.** The below chart[3] represents the saving deposits and monies held in % of total financial assets in the OECD. It might be useful to learn from the examples of broader equity culture existing in certain countries such as in Scandinavian and the Baltics (reflected in the comparatively little amount of economically unsound savings deposits).

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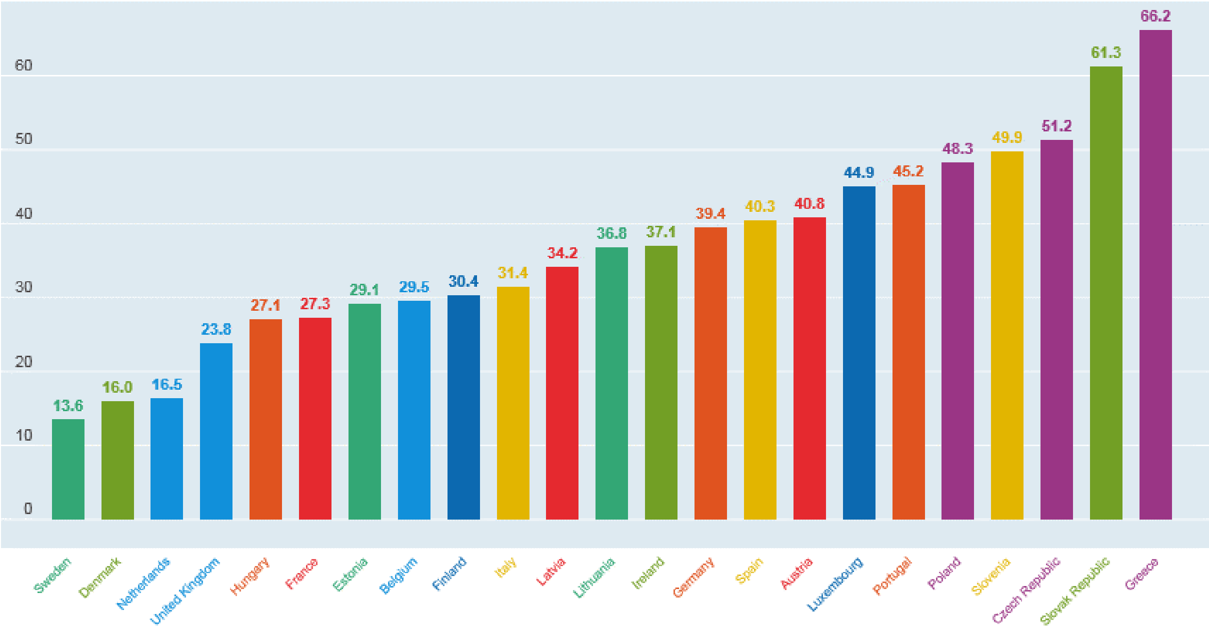
[3] https://data.oecd.org/hha/household-financial-assets.htm



Currency and deposits, % of total financial assets, 2016 (OECD)

4. Disclosure of Environmental, Social and Governance (ESG) factors and the contribution of such disclosure to long-term investment strategies (Section 3)

26. Section 3 of the questionnaire wishes to examine how and to what extent public disclosure of ESG-factors can enable investors to integrate in their investment decision-making considerations on **companies' current and** future **ability to create long-term value for their shareholders and society at large**. The questions as laid out in the survey only partially reflect this. They point to a more general assessment of the reports created for the past years 2017 and 2018 under the NFRD **disregarding unsolved pre-requisites of CSR-reporting**. It is also doubtful whether the relevant section of the survey addresses **short-term pressure from** the financial sector or the unsatisfactory reporting by issuers, who are potentially creating such **pressure on the financial sector.**

27. As the SMSG stated in its Advice on integrating sustainability risks and factors in MIFID, the UCITS Directive and AIFMD earlier this year (ESMA22-106-1683), **current CSR-Reporting faces a number of shortcomings.** These partly originate from the high level of uncertainty about the underlying concepts and their legal – soft and hard – framework. Moreover, the most commonly used frameworks lay out principles of responsible enterprise but don't provide a proficient methodology on CSR-performance. As a consequence, **data quality, accuracy and availability** are most difficult to assess and often lack comparability. Encouraging the future oriented communication by firms, particularly on strategy, key performance metrics and the transition path (to a low carbon economy, to the implementation of the TCFD recommendation or to any other stated objective) would help to embed long-termism and likely facilitate stakeholders to get an integrated view of the firm (e.g. monetary value of the environmental actions and footprint). Further shortcomings are created by the **absence of an ESG-related accounting framework**. Accordingly, investment decisions – be they long- or short-term – based on ESG-factors face major hurdles.

28. In the light of the shortcomings of NFRD-data little insight can be expected from the results of this section of the questionnaire. In particular it would be **premature to conclude that current deficits of sustainability reports are a result of the flexibility granted to reporting companies when prioritizing their sustainability efforts**. The SMSG also likes to highlight that NFRD-reporting is undergoing thorough monitoring in the Member States. This might produce relevant evidence for more detailed approaches to improve data quality. Further analysis by ESMA and other ESAs should consider these findings. They should also take into account the effects of the ongoing debate on taxonomy and the recently amended guidelines on NFR. Both may help to clarify the need for future regulation.

29. However, accessing adequate input data helps in making informed decisions and in analysing the long-term prospects of underlying investments. SMSG members believe that the accuracy and availability of data is a major challenge for the investing community to be able to make valuable decisions.

30. Another important feature of ESG-consideration in investment decision making is the **role of proxy advisors**. Recent analysis done in the U.S. indicates that proxy advisors include NFRD or corporate sustainability in their services (voting and consultancy) in a rather diverging manner. It is reasonable to assume that this is connected to the deficits of CSR data quality. However, the respective providers may also **interpret sustainability in different ways**. This also should be further examined before conclusions regarding NFR-obligations are drawn.

5. The role of fair value in better investment decision-making (Section 4)

31. The role of fair value in asset evaluation is a highly complex issue. The SMSG would like to encourage ESMA to conduct a thorough analysis. At this point the group wishes to confine itself to the following remarks.

32. Fair value as defined in IFRS 13 in the aftermath of the financial crisis has become the reference value in international accounting for financial assets. IFRS 9 that entered into force on 1 January 2018 was developed by considering fair value through profit and loss as the default measurement value as well as the only measurement applicable to investment (mutual) funds. Extending the scope of fair value accounting to all (also new) financial instruments for all investing business models came with a **higher volatility of balance sheets and income statements** of companies in the scope (see eg. Novoa, Scarlata, Sole: Procyclicality and Fair Value Accounting, IMF Working Paper 9/39) compared to e.g. the historical cost accounting method. **Indeed, fair value measurement does not fit all cases, notably when investments are not made with the intention of being rapidly disposed of or where they are held precisely with the purpose of matching identified long term liabilities.** The business model of the investor, part of the IASB principles, should also be able to be accounted for when treating equity and equity like (funds) instruments.

33. For equity instruments (whether held directly or indirectly through funds), the use of fair value through profit and loss **leads to a situation that does not/no longer reflect the real economic value as the assets concerned are not held with the intention of an immediate sell**. The result is **increased uncertainty regarding** valuations, which makes it more difficult for supervisors to initiate appropriate regulatory measures in particular to **deal with prudential concerns**. Where the intention is to keep the position for a longer term, it should be possible to keep investments (be they equity, bonds, more or less liquid assets or other strategies and long term portfolios) at their book value (which is not necessarily static depending on the nature of the impairment) or other types of efficient accounting, such as fair value with changes in fair value presented in Other Comprehensive Income (OCI) and recycled (reclassified) to profit or loss on disposal. The current IFRS 9 does not permit an adequate and complete solution for equity and equity-like instruments kept long term, since fair value through profit and loss treatment adds unnecessary volatility and the solution of fair value with OCI without the possibility of reclassifying to profit and loss ("recycling" and "impairment") does not permit recognizing gains or losses upon disposal. This is why a consistent dual measurement solution for both equity and equity-like instruments could be a viable amendment to IFRS 9. It would help avoiding unduly discouraging of long-term investments by corporations.

34. It may also be worth to note that the IASB and national standard setters, such as the German Deutsches Rechnungslegungstandard Committee (DRSC), have recently expressed **reservations in respect of whether ESG-criteria could (or should) be "translated" into the existing fair value principles**. What matters in our opinion is to stick to the European Commission's objective of ensuring that accounting standards do not hinder long term investment. We remind that the EU High-Level Expert Group also advises "to ensure that EU accounting rules do not unduly discourage long-term investment". SMSG members believe this is an area that needs further investigation regarding (unintended) short-termism incentives. The EFRAG's IFRS 9 consultation was more than welcome and we would have liked to see more types of asset classes (also held through funds) allowed within the equity and equity like accounting framework.

6. Institutional Investors and the Role of Proxy Advisors (Section 5)

35. The **regulatory framework strongly affects** how institutional investors allocate their assets and consequently what their **"aggregate holding period"** is. The **combination of mark-to-market valuation methods, risk-based capital requirements, and liquidity requirements, may encourage procyclicality and shorten the investment horizon of institutional investors**. For instance, Solvency 2 discourages insurances companies, which are natural long-term investors and clients of asset managers, from investing in long term assets like equity. Fine-tuning reviews of Solvency 2 should attribute a lower capital charge for ELTIFs and more recently for "long-term equity investments". However, it should be noted that the terms and conditions attached to new treatments are constraining (e.g. stringent liquidity stress tests, strict holding period of 5 years, only EEA assets) and might therefore not have the desired impact to boost further investment in long-term assets. The upcoming general review of Solvency 2 should aim at simplifying this framework. In particular it should be directed to increase the aggregate long-term exposure to long-term assets like equity but not necessarily impose a mandatory holding period for each asset.

36. To assess current behavioural patterns, it is important to notice that the revised **Shareholder Rights Directive (SRD II) has not yet been implemented,** so its effect remains to be seen. SRD II requires Member States to ensure that institutional investors disclose how their investment strategy is aligned with the profile and the duration of their liabilities, and how it contributes to the medium to long-term performance of their assets. This marks a strong **focus on transparency and disclosure** and is an important first step.

37. Proxy advisors play a key role in helping addressing institutional investors' engagement. Given the large and diverse portfolios of institutional investors, proxy advisors are almost inevitable and useful in the engagement process of institutional investors intending to comply with the fiduciary duty they owe their clients. Given this important role of proxy advisors, the SMSG considers that, as it has likewise focused on transparency and disclosure of the proxy advisory industry (the Best Practice Principles Group) only, further steps to avoid conflicts of interest should be encouraged.

38. The SMSG acknowledges that securities lending, if done in a controlled way, is an opportunity to add value for fund investors and compatible with long-term investment strategies, and contributes to market liquidity and price discovery. Transparency is important to allow end investors to understand funds' securities lending practices and to decide whether they want to invest in a fund that pursues such practices.

7. Remuneration of fund managers and corporate executives (Section 6)

39. **Remuneration for fund managers is already regulated by the UCITS and AIFM directives.** Senior management, risk takers (such as the portfolio managers) and control functions are covered by these rules. The CRD rules would apply for these categories of staff when they are employed by a bank and soon, pursuant to the Investment Firms Directive, which was approved on 16 April 2019 by the EU Parliament, when they are employed by an investment firm.

40. **Article 13 and annex II of directive 2011/61/EU (AIFM) and article 14b of directive 2009/65/EC (UCITS) include specific and key provisions to align interests between fund managers and investors in the long term**. For instance, in order to ensure that fund managers have a long-term incentive, at least 50% of the variable remuneration should be paid in instruments related the fund managed (e.g. shares of the fund). Furthermore, at least 40% of the variable remuneration should be deferred to keep incentives fully aligned. Both directives state that: “the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the AIFM as a whole, and justified according to the performance of the business unit, the AIF and the individual concerned.” Both UCITS and AIFMD contain remuneration disclosures requirements allowing scrutiny from investors and national competent authorities.

41. The SMSG would also like to point out that the Shareholders Rights Directive II, for which national transpositions were due by 9 June 2019 (in articles 3g, 3h and 3i) has created a set of comprehensive annual disclosure requirements addressing among other things **the medium and long term risks** of investment strategies of asset managers, **turnover and turnover costs** in portfolios and **whether/how investment decisions are based on medium/long-term performance** in particular.

40. Besides, **ESMA has produced guidelines[4] and Q&As on remuneration ensuring a consistent application of the framework and highlighting good and poor practices** in order to align the interests of investors and fund managers in the long-term. It should be acknowledged that:

1. this current set of rules constitutes a robust framework aiming to align interests of investors and fund managers in the long-term,
2. there still is a regulatory gap with requirements in this respect in non-EU regulated markets.

8. Use of CDS and Derivatives by Investment Funds (Section 7)

42. SMSG members to a certain extent **fail to see the link between short-termism incentives in financial markets and the use of derivatives by investment funds**. They also wonder why the **survey singles out CDS** specifically out of all types of derivatives.

43. Derivatives are instruments that permit users to gain exposure to or to hedge against a market segment or risk/. Rolling derivatives is quite **often a way to maintain a position for a longer term**. The use of CDS to buy or sell credit protection by investment funds does not necessarily contribute to short-termism in markets. For example, this strategy may be adopted to address the issue of scarcity or mispricing in the bond market. Market liquidity for a specific bond the fund manager is trying to buy may be poor at the time the fund manager elects to increase exposure, making it difficult to find an acceptable price or to find a market for the full size. In this case the fund manager could turn to the CDS market, selling protection on the relevant reference entity, and gain credit exposure on the relevant bond. Selling protection can be viewed as essentially identical to the credit exposure from taking a long bond position. When the bond is tradable on more favourable terms the fund manager can then choose to switch exposure from CDS exposure into the specific bond.

[4] https://www.esma.europa.eu/press-news/esma-news/esma-issues-guidelines-remuneration-practices-under-ucits-and-aifmd

44. As far as the **risk side** is concerned, Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps has already provided a regulatory response by banning naked short selling as well as naked sovereign CDSs. In addition, the aforementioned regulation introduced mandatory transparency in respect of net short positions.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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