AMIC answer to ESMA's survey on short-term pressure from the financial sector on corporations

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA (EU Transparency Register Number: 0223480577-59) is one of the few trade associations with a European focus and both buy-side and sell-side representation. AMIC welcomes the opportunity to respond to this survey on possible short-term pressure from the financial sector on corporations.

ICMA has a long-standing engagement on sustainability issues through running the secretariat for the Green Bond Principles Executive Committee, which produces the Green Bond Principles, the Social Bond Principles and the Sustainability Bond Guidelines. However, this response is primarily drafted on behalf of ICMA's buy-side AMIC members.

Executive summary:

- Asset managers business models revolve around protecting and enhancing their clients' assets in the long-term.
- Short-termism should not be confused with finance with a shorter duration such as liquidity management, treasury, trade credit and other financing of short duration.
- As fiduciary asset managers, AMIC members are pursuing sound corporate governance practices at the level of investee companies to protect and enhance the long-term economic value of their clients' assets.
- How asset managers hold any asset is a function of how long clients stay with a product but generally asset managers tend to hold assets for the long-term based on their analysis of a company's prospects and underlying performance. If there are short term opportunities in the market, value is created in the long term. However, asset managers are also continuously assessed against market benchmarks which challenges their ability to take a longer-term view and tolerate periods of underperformance even by firms in which they fundamentally believe.
- Investment horizon and possibilities for institutional clients are very dependent on their regulatory framework (accounting, prudential, liability requirements). Investors and therefore asset managers could become even more long-term oriented if the Capital Markets Union project is completed and some key regulations could be amended in a positive way.
- The Non-Financial Reporting Directive can provide asset managers and investors with relevant information on sustainability factors and risks that may foster further capital allocation to sustainable assets. It is important however to also consider the future impact of other sustainability initiatives promoted by the Commission and/or proposed by the EU TEG on Sustainable Finance that will likely contribute to significant portfolio reallocation and rotation by identifying sustainable activities and/or sustainability risks. These are the EU Taxonomy and the Guidelines for Disclosures on Environmental and Social Information.

- IFRS 9 will indeed introduce more day-to-day volatility in insurers' and non-financial corporations' P&L statements, potentially resulting in less equity investments (in particular UCITS funds) from long-term institutional investors.
- Asset management remuneration rules, which were very recently adopted by the co-legislators (involving ESMA itself) and are set to align interests between fund managers and investors in the long term, should not be a source of concern.
- Likewise, sell-only or net sell CDS positions held by UCITS funds is not to be necessarily assimilated to short-termism. This indeed may be to address the issue of scarcity or mispricing in the bond market.
- We do not see short termism as a prevalent bias of asset managers or investors although we recognize certain factors that can contribute to shorter-term outlooks such as certain market benchmarks. We would also underline that the pursuit of sustainability may contribute to portfolio rotation and re-allocation as asset managers and investors seek to align with new guidance and to the disclosure of new sustainability related risks. It would be highly problematic to take any measures aimed at perceived short termism that would impede this necessary adaptation and flexibility.

Section 2: investment horizon and investment strategies

8. Which time horizon do you apply in your general business activities?
9. In your experience, to which extent do the following nodes in the investment value chain contribute to the tendency towards short-termism?
10. To which extent does each of the following factors result in short-termism by your institution?
11. What is the actual holding period prevailing in your investment strategy?
12. To which extent does each of the following factors drive the actual holding period prevailing in your investment strategy?
13. On a best-effort basis, in the next 2 years, how do you expect the average holding period of the following portfolios to evolve?

- **Asset managers should not be portrayed as being short-term when their business models revolve around protecting and enhancing their clients' assets in the long-term:**

    - **Asset managers are different from traders**. Traders account for most of equity market turnover, while most shares are held by investors. Analysis of UK asset managers has indicated an average holding period of 6.3 years for UK listed companies (Oxera report July 2016). Traders tend to be driven by short-term market trends and turn their portfolios over rapidly, whilst asset managers tend to hold them for the long-term based on their analysis of a company's prospects and underlying performance. Not to say that trading activity is unproductive: it allows to perform key functions of markets (liquidity, price discovery).
    - However, asset managers need to grow/protect investors assets which can lead to **portfolio turnover**, which is not antinomic with long-term investment. Investors are simply re-investing in assets presenting better risk-reward ratios. It is a sound practice especially when assets are over-valued.

- **How long asset managers hold any asset is therefore a function of how long clients stay with a product.**
    - **The investment horizon varies according to investors' profile/needs and type of funds/assets.** Asset managers provide different investment solutions to meet clients' needs. The minimum recommended holding period depends on the type of funds and underlying assets:
        - money market funds: 1 day to 3 months
        - equity fund: > 5 years
        - ELTIFs: > 10 years
    - **For each category of investment solutions fund managers might apply different strategies which might require more or less time to generate returns for investors**. In theory a contrarian approach whereby the fund manager buys shares of good companies in a bear market might require a longer holding period to generate returns for investors. A momentum strategy whereby a fund manager buys outperforming shares might have a relatively higher portfolio turnover and shorter time horizon for a specific asset, but it will still be exposed in the long run to the equity market.
    - Although markets tend to be volatile over the short-term, they have historically produced strong results over the long-term. Asset managers perceive buying opportunities during market downturns and act by nature as **counter-cyclical investors,** therefore **contributing to market stability and resilience.**
- **It must be made clear that investors with short-term investment horizons and high liquidity needs are not be confused with short-termism.** Typically, investing in the long run in shorter duration such as liquidity management, treasury, trade credit and other financing of short duration could perfectly qualify as a sound long-term strategy for investors having for instance specific regulatory or liability constraints.
- **Investors and therefore asset managers could become even more long-term oriented if the Capital Markets Union project is completed and some of its key regulations could be amended in a positive way:**
    - **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 and accounting (see section 4 for **IFRS 9**), risk-based capital requirements, and liability 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. We welcome the successive fine-tuning reviews of Solvency 2 to attribute a lower capital charge for ELTIFs and more recently to "long-term equity investments". However, we would like to highlight 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 into long term assets. We therefore hope that the upcoming general review of Solvency 2 will simplify this framework. When conducting this review, we should try to increase the aggregate long-term exposure to long-term assets like equity and not necessarily impose a mandatory holding period for each asset.

- **ELTIFs:** Only a small amount of ELTIFs were launched since the application of the regulation on 9 December 2015. While remaining respectful of the need to provide the right degree of control to satisfy legitimate concerns, such as investor protection, we would recommend considering improvements on **(1) eligible assets and (2) investor eligibility rules** to facilitate the take-up of ELTIFs and significantly boost their contribution towards the financing of much needed longer-term investment. (1) The **limitations for fund of funds solutions** has been criticised by the fund industry, as it restricts effective in these illiquid assets. During the portfolio build-up phase the ability to invest on a broader basis in funds other than ELTIF would allow for a faster deployment of capital. **Real assets** such as commercial property and housing are a key asset class in the European and global private fund market, but the subjective and potentially restrictive eligibility requirements in the ELTIF regulation have limited the use of ELTIFs for real asset funds.
  (2) A **retail investor** whose portfolio composed of cash deposits and financial instruments is smaller than €500,000 is not allowed to invest an aggregate amount exceeding 10% of his portfolio in ELTIFs, provided that the initial amount invested in one or more ELTIF are no less than €10,000 (although if investing in more than one ELTIF the minimum in any one ELTIF out of the €10,000 is €2,000). The relevance of establishing limits is easy to appreciate, yet the way these are structured leads to a requirement which is challenging to apply – as it is far from straightforward to be able to verify and comply with these limits. Ultimately this provision added to the complexity of producing a PRIIPS KID for an ELTIF (e.g. transaction costs), and the need to conduct in parallel the MIFID II suitability requirements has discouraged the distribution to retail investors as intended by the ELTIF regulation.

Section 3: use of non-financial disclosure reporting

15. Based on your experience, please indicate to which extent you agree with the following statement: "Disclosure of ESG information by listed companies enables investors to take long-term investment decisions".
16. Assuming that investors are willing to consider ESG disclosure in their decision-making process, why does disclosure of ESG information by listed companies not enable investors to take long-term investment decisions?
17. Why does disclosure of ESG information by listed companies enable long-term investment?
18. Even though you acknowledge that disclosure of ESG information by listed companies could enable long-term investment, you might have observed impediments as to how this link may work in practice. To which extent each of the following factors may discourage investors from using ESG disclosure to apply a long-term investment horizon?
19. In your view, would requiring specific disclosures on intangible assets which are not accounted for in the financial statements enable long-term investment decisions?
20. The NFRD gives companies flexibility to disclose non-financial information to the extent necessary for an understanding of the undertaking's development, performance, position and the impact of its activity in relation to non-financial matters. Do you consider that further requirements are needed to increase the level of detail in the disclosure requirements regarding non-financial information?
21. Do you consider that further steps in the area of non-financial reporting are needed at the national or the European level to enable investors to take long-term investment decisions?

Asset managers increasingly seek to integrate an assessment of material sustainability opportunities, factors and risks in their investment process and decisions to fulfil the long-term obligations to their clients. **We therefore welcome the Non-Financial Reporting Directive which already encourages companies to disclose relevant, material ESG information which helps companies disclose in a consistent and more comparable manner**. This information will contribute to a long-term investment outlook incorporating sustainability, but it is important to underline that it will not necessarily lead to longer term investment or greater portfolio stability.

Indeed, sustainability initiatives promoted by the Commission and/or proposed by the EU TEG on Sustainable Finance such as the EU Taxonomy and the Guidelines for Disclosures on Environmental and Social Information identify sustainable activities and will lead to the recognition of sustainability risks. This will likely contribute to significant portfolio reallocation and rotation which should not be construed as short termism but will reflect a necessary adaptation that may need to take place over at least the medium term. It would be highly problematic to take any measures aimed at perceived short termism that would impede this necessary adaptation and flexibility.

<u>Section 4: the role of the fair value in better decision making</u>

22. Based on your experience, please indicate to which extent you agree with the following statement: "For the purpose of undertaking an internal assessment of the performance of long-term investments held in equity instruments, fair value provides a company's management with relevant information in order to better understand the short-term and the long-term consequences of the investments held"
23. Based on your experience, please indicate to which extent you agree with the following statement: "For the purpose of enabling an external analyst or investor to assess the performance of long-term investments held in equity instruments by a company, fair value provides relevant information in order to better understand the short-term and the long-term consequences of the investments"
24. Is the current accounting treatment for equity instruments under IFRS 9 [1] a decisive factor in discouraging a company from undertaking new long-term investments in equities?
[1] Under IFRS 9 Financial Instruments equity instruments are accounted for at fair value with the possibility to exclude fair value changes from the statement of profit or loss
25. Is the current accounting treatment for equity instruments under IFRS 9 [1] a decisive factor in triggering divestment by a company of existing equity holdings elected for the long-term?
[1] Under IFRS 9 Financial Instruments equity instruments are accounted for at fair value with the possibility to exclude fair value changes from the statement of profit or loss
26. In your view, what are the factors that may impact the relevance to users of financial statements of fair value measurements for long-term investments?

IFRS 9 has indeed introduced more day-to-day volatility in insurers' and non-financial corporations' P&L statements, as a result of new mark-to-market requirements of unrealised gains/losses and forward-looking, estimated impairment charges of existing "equity investments". **Some members reported that under IFRS 9 the treatment of funds does not even qualify as "equity instruments" placing them at a disadvantage compared to direct equity holdings**, triggering switching from UCITS to mandates (direct investments) or dedicated funds. In order for funds not to be at disadvantage when compared to direct investment, profits or losses realized on funds units or shares should be allowed to recycle in P&L when accounted for as FVOCI.

Section 5: institutional investors' engagement

27. Is your investment strategy predominantly active or passive?
28. Please elaborate on how the actual holding period of your investments (as you have indicated under question 11) matches with your investment mandate
29. To which extent does your firm integrate long-term value considerations for the purpose of setting its investment strategy (and subsequent portfolio allocation choices)?
30. To which extent does your firm integrate long-term value considerations for the purpose of setting its engagement policy (and subsequent engagement activities)?
31. How does your firm engage with the investee companies in order to mitigate any potential sources of undue short-termism?
32. What are the main topics your firm engages on in order to mitigate any potential sources of undue short-termism?
34. Please indicate your agreement with the following statement: "Proxy advisors take into consideration long-term value when they provide voting advice"
35. Please indicate your agreement with the following statement: "Engagement activities can be an efficient way of mitigating any potential sources of undue short -termism"
36. To which extent do you consider your engagement activities successful in mitigating any potential sources of undue short-termism?
37. Which are the main obstacles that institutional investors face when engaging with investee companies, and how could they be addressed in your view?
38.Please indicate your agreement with the following statement: "The recent entry into application of the revised Shareholder Rights Directive is going to increase the extent to which your firm takes into account long-term value considerations for the purpose of setting your investment strategy and engagement policy"

As fiduciary asset managers, AMIC members are already pursuing sound corporate governance practices at the level of investee companies to protect and enhance the long-term economic value of their clients' assets. They focus among others on assessing the quality of management, board leadership and standards of operational excellence at the public companies in which they invest on behalf of their clients. Our members have dedicated teams to engage positively with investee companies.
Active investors need ongoing contact with companies to support their investment decisions and to understand changes in companies' strategy and prospects. The questions these investors ask, and the changes in company practice that they advocate for, send clear signals of their expectations, which can influence companies. Active investors with longer time horizons are likely to encourage companies to focus on longer term factors that will affect performance, including sustainability.
Passive investors hold companies for as long as they remain in the index (while adjusting the size of their position to reflect changes in market capitalisation). They are therefore long-term investors in many companies. They also particularly attach importance to stewardship (engagement and voting) because they recognize its importance to long-term value creation.

In some markets a number of our members experience a degree of reticence from management and non-executive board members to engage with shareholders. We therefore welcome the adoption of the Shareholders Rights Directive 2 and the revision of the UK Stewardship Code which will contribute to enhance this dialogue and codify the expectation for companies to engage with shareholders. However, these new rules should be applied in way that protects the confidentiality of the contractual relationship between an investor and his asset manager.

Section 6: remuneration of fund managers and corporate executives

Part A: remuneration of identified staff in funds
39. What is the average investment horizon of the funds managed by your firm?
40. In the salaries of identified staff [1] of your firm's funds, what is the average share of the variable component compared to the fixed component?
41. Over what average time is the reference period for variable remuneration calculated for the identified staff of your firm's funds?
42. What average percentage of variable remuneration do you defer for identified staff of your firm's funds?
43. On average, over what period do you defer the payment of the variable remuneration for identified staff of your firm's funds?
44. Do you believe there are common practices in the remuneration of fund managers that contribute to short-termism?
Part B: Remuneration of corporate executives
45. In your firm, what is the average share of the variable component of executive remuneration compared to the fixed component?
46. Over what average time is the reference period calculated for variable remuneration of your firm's executives?
47. Over what average period is the payment of the variable remuneration of your firm's executives deferred?
48. Is the awarding of variable remuneration to your firm's executives linked to any ESG-related objectives?
49. Do you believe there are common practices in the remuneration of corporate executives that contribute to short-termism?

Remuneration for fund managers is strictly regulated by UCITS and AIFM directives. Senior management, risk takers (such as the portfolio managers), control functions are covered by these rules. Some additional rules might apply for these categories of staff when they are part of a banking group (subject to CRD) and/or an investment firms (subject to MiFID).
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 the long-term incentive is maintained, it is required that at least 50% of the variable remuneration is paid in instruments related to the fund managed (e.g. shares of the fund). Furthermore, it is required that **a** least 40% of the variable remuneration is 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 disclosure requirements allowing scrutiny from investors and national competent authorities.

On top of these rules, ESMA has produced guidelines[1] and Q&As on remuneration ensuring a consistent application of the framework and highlighting poor and best practices. We are therefore surprised to see this extensive set of rules being suspected of driving short-termism when they were precisely put in place recently to align interests of investors and fund manager in the long-term.

Section 7: use of CDS

50. What percentage of your funds are exposed to CDS?
Please indicate the closest applicable percentage and use 0 to indicate 'not applicable'
51. If your funds are exposed to CDS, what are they primarily exposed to?
Please fill in the table with the applicable percentages and use 0 to indicate 'not applicable'
In case you reported a non-zero percentage to Other in question 51, please specify which kind of CDS you are referring to
52. What kinds of CDS exposures do your funds hold?
Please fill in the table with the applicable percentages and use 0 to indicate 'not applicable'
53. If any of your funds hold sell only or net sell CDS positions, what is their primary investment strategy?
54. What is the average size of your fund's holding of sell only or net sell CDS exposures, expressed in assets under management (AUM)?
Please select the relevant range for each category
55. If you hold sell only or net sell CDS positions in any of your funds, please select in the list below one or several reasons for holding sell only or net sell CDS positions56. If you hold sell only or net sell CDS positions in any of your funds, do you:
57. Are there other classes of derivatives used by investment funds that could increase short-termism in the economy?

Sell-only or net sell CDS positions held by UCITS funds is not to be necessarily assimilated to short-termism. This indeed may be to address the issue of scarcity or mispricing in the bond market. It may be that market liquidity for a specific bond the fund manager is trying to buy could be poor at the time they elect to increase exposure, making it difficult to find an acceptable price or to find a market for their full size. In this case they could turn to the CDS market, selling protection on the relevant reference entity, and so gaining their bond exposure until liquidity improves. Selling protection can be viewed as identical to the credit exposure from taking a long bond position. When the bond is traded on more favorable terms the fund manager can then switch exposure from CDS exposure into the bond.

ENDS
29 July 2019

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