ESMA publishes a Report on undue short-term pressure on corporations. International Bulletin of February 2020.

On 19 December, the European Securities and Markets Authority (ESMA) published a report on undue short-term pressure on corporations. The report responds to a request from the European Commission (the Commission) to the European Supervisory Authorities for each of them, within their area of competence, to investigate the possible sources of this type of pressure from the financial sector on corporations, to gather evidence, to analyse current regulations to see which ones contribute to short-termism and which ones mitigate it and to make proposals for action based on the results of this analysis. It should also be noted that this initiative is part of the Commission's Action Plan on Financing Sustainable Growth, which includes fostering transparency and long-termism in financial and economic activity as one of its three objectives.

The Report Preparation Process

To fulfil the mandate of the Commission, ESMA did the following: a) it reviewed the relevant financial literature on the subject; b) it published a survey aimed at investors, issuers, UCITS management companies, self-managed UCITS investment companies, Alternative Investment Funds Managers and the trade associations of the aforementioned financial market participants to gather their opinions and experience in relation to the issues identified below, as well as other possible sources of short-termism; c) it consulted its Securities and Markets Stakeholders Group (SMSG); and d) it held a stakeholder workshop in which the results of the survey were presented in order to collect information on market practices and the opinions of the participants in the financial markets.

After a preliminary review of the relevant financial literature, ESMA identified a series of areas on which to continue research to substantiate its relevance when it comes to inducing short-term pressure: 1) investment strategy and investment horizon; 2) contribution of disclosure of Environmental, Social and Governance (ESG) factors to long-term investment strategies; 3) role of fair value in the best investment decision-making; 4) institutional investor engagement; 5) remuneration of fund managers and corporate executives (these points are addressed separately in the report); and 6) use of credit default swaps (CDS) by investment funds. The last point was added to the survey to provide context to the other areas.

Conclusions of the Report

Each issue is analysed in the report as follows. Firstly, the existing regulatory framework in relation to this issue is presented. The evidence collected in the financial literature and in the public survey as well as the opinion of the SMSG and the comments made in the stakeholder workshop are detailed below. The following is an analysis of all the information collected, that is, how the evidence supports or does not support the existence of short-term pressures. Finally, as a result of the conclusions of the analysis, a series of measures are proposed to the Commission.

These are the main conclusions of ESMA's analysis and their recommendations:

1) Investment strategy and investment horizon

Regarding how investors prioritise the long or short term in their investment activities, ESMA observed that while respondents in general considered a long-term investment horizon to be longer than six years, the most common time horizon for general business activities was less than five years and the average holding period for both equities and bonds was one to four years. However, ESMA has considered that there is no clear evidence since a historical comparison has not been made and there are different macroeconomic and monetary policy factors that can affect investment decisions; therefore, it is difficult to make concrete policy proposals in this regard.

On the other hand, many respondents believe that sell-side analysts contribute greatly to short-termism, so ESMA believes that this may indicate a general short-term focus in investment research. ESMA believes that this may be due to:

a) The shortage of relevant data from issuers with company disclosures focusing on the short term. The improvement in ESG disclosures can address this since this information is more focused on the long term.

b) The lack of demand on the buy-side as investors tend to trade their assets with short-term horizons. ESMA believes that this can be addressed by the measures that the Commission intends to take to clarify the duties of insurance companies, advisers and asset managers regarding sustainability risks and their integration into organisational requirements. *ESMA recommends monitoring whether the integration of sustainability risks helps deliver greater focus on long-term risks in investment research.*

In addition, the Commission will review some aspects of the investment research contained in MiFID II, therefore *ESMA recommends that the Commission takes the finding regarding sell-side analysts into account when conducting its review.*

2) Contribution of disclosure of ESG factors to long-term investment strategies

The information collected by ESMA seems to confirm that ESG disclosure can support investors in taking long-term investment decisions. However, work is still needed to improve the quality of this information and ensure a minimum level of comparability, relevance and reliability.

In this regard, ESMA believes that some specific aspects of the implementation of the Non-Financial Reporting Directive (NFRD) may present obstacles to the adequate ESG disclosure. To overcome the main obstacles identified, ESMA proposes three amendments for consideration by the Commission:

a) To remedy the lack of more specific requirements on how to prepare both narrative and quantitative disclosures in the areas addressed by the NFRD, *ESMA proposes that as a first step, the Commission should adopt delegated acts to specify the key general principles for high-quality non-financial information and to establish a limited set of specific reporting requirements. In the medium term, ESMA suggests that the Commission promotes the adoption of a set of international ESG disclosure standards.*

b) Since there are no specific requirements on where to include the non-financial statement and the assurance of the information contained therein, there has been a divergence in practices among the different Member States. *ESMA proposes that the Commission requires the inclusion of the non-financial statement in the annual financial report, as well as the assurance on its content and consistency with the other information contained in that report.*

c) The non-financial statement is not a requirement included in the Transparency Directive, but in the Accounting Directive, so it falls outside the scope of supervision of some competent national authorities. Another reason why ESMA considers it important to include references to the non-financial statement in the Transparency Directive is so that issuers take responsibility for the content of that statement. For these reasons, *ESMA proposes that the necessary coordination be established between the NFRD and the Transparency Directive.*

3) Role of fair value in the best investment decision-making

Neither the information collected in the public survey nor that from financial literature seems to indicate that fair value measurements produce distortions in the investment process that result in undue short-term pressures in financial markets. In addition, both managers and investors consider fair value as a relevant measurement basis compared to other alternatives, thus providing the necessary transparency to promote long-term investment. On the other hand, there is still no evidence of consequences of the application of the International Financial Reporting Standard (IFRS) 9 on long-term investment practices. Finally, it is emphasised that the selection of investment horizons does not depend fundamentally on the use of fair value for equity and equity-like instruments as provided for in IFRS 9. For these reasons, *ESMA believes that it is not necessary to amend the existing requirements for fair value measurement in order to avoid undue short-term pressures.*

4) Institutional investor engagement

As to how the engagement of institutional investors can contribute to long-term value maximisation of investee companies, the recommendations are based on the following issues:

The Shareholder Rights Directive (SRD II) provides a set of provisions to encourage the shareholders engagement in EU listed companies, including the active exercise of ownership rights. However, due to its recent application, its effects cannot be evaluated yet, so *ESMA recommends that the SDR II be monitored to see whether it is effective in achieving long-term shareholder engagement.*

The results of the public survey indicate that long-term engagement increasingly addresses issues related to sustainability. However, although there is a broad consensus on the increasing importance of sustainability factors and risks in establishing the issuers' strategy, there are different positions on whether the sustainability-related disclosures should be subject to shareholders opinion. In this regard, *ESMA suggests that the Commission should consider whether, for those companies required to publish non-financial statements, an advisory vote on the document would help investors express any concerns about the way in which the investee issuers approach sustainability risks.*

On the other hand, while the collective engagement of investors is considered the most effective form, there are regulatory risks arising from cooperation. ESMA believes that actions could be taken in areas of the regulatory framework that can facilitate collective engagement, for example by providing further clarity on the boundaries of acting in concert by institutional investors. For this reason, *it is recommended that the Commission ask ESMA to review its Public Statement on Information on shareholder cooperation and acting in concert under the Takeover Bid Directive (the White List). It could be assessed whether the White List should explicitly include coordination activities among institutional investors in the area of ESG risks.*

The public survey also asked about the role of the proxy advisor in the context of long-term engagement and some respondents expressed doubts about the possibility of these advisors taking into account long-term considerations in facilitating their voting recommendations. This issue is addressed by SRD II, which establishes a series of provisions to reinforce the role of the industry's self-regulatory code. *ESMA recommends that the Commission assess whether the current approach envisaged in SDR II has been effective from this perspective in ensuring that proxy advisors do not contribute to undue short-term pressures on listed companies.* The review of SDR II is scheduled for June 2023.

Finally, *ESMA proposes that the Commission should assess the impact of national legislation that has recently introduced additional incentives (such as increased voting or dividend rights) to promote shareholders' long-*

term perspective. ESMA believes that the impact of these national standards should be assessed before considering their application at European level.

5) Remuneration of fund managers

In relation to the impact on undue short-termism of remuneration policies and practices of fund managers, in recent years, a series of measures have been adopted on the remuneration of fund managers. For this reason, ESMA believes that there is no need to adopt other legislative measures on the matter at this time. However, *ESMA believes that the Commission should monitor the effect of the Sustainable Finance Disclosure Regulation requirement on UCITS management companies and AIFMs to disclose information in their remuneration policies on how those remuneration policies are consistent with the integration of sustainability risks before assessing a potential need for further regulatory amendments.*

6) Remuneration of directors in listed companies

In relation to the impact that remuneration and incentives for senior managers may have on the pursuit of short or long-term performance, the legal framework has recently been amended with the intention of reducing potential undue short-termism. In this regard, the Commission is working on the development of guidelines to specify the standardised presentation of the remuneration report under the SRD II. The importance of improving disclosure and investors' monitoring of remuneration, including in connection to financial and non-financial performance criteria is recognised.

With respect to the guidelines being developed by the Commission, ESMA makes a number of recommendations: a) that, once the guidelines are issued, it should consider recommending that companies use the envisaged standard tables unless they have appropriate justification; b) that it should consider whether the criteria for the standardised presentation of variable remuneration, as well as performance criteria and their application could be tailored to accommodate ESG criteria and require an appropriate explanation whenever they are not used; and c) that it should monitor the implementation and effectiveness of the guidelines and consider the use of more binding tools if the appropriate level of convergence is not achieved.

Finally, *ESMA proposes that the Commission consider requiring Member States to have an adequate independent monitoring framework, possibly with some degree of public sector oversight, to ensure the quality of information disclosed in remuneration reports published by companies.*

7) The use of CDS swaps for investment funds

Recent empirical evidence suggests that the use of CDS by UCITS funds is limited; however, some funds that have sell-only or net-sell exposures to CDS and use them for short-term profit enhancing, may be exposed to significant contingent risk in case of a default by the underlying reference entity. However, *the limited evidence collected by ESMA has not made it possible to draw solid conclusions on this matter.* In any case, this Authority will continue to monitor this matter from the perspective of financial stability and investor protection.

8) Other sources of short-term pressures

Finally, ESMA received information from respondents, the SMSG and the participants in the stakeholders workshop about other factors not included in the public survey that were deemed relevant to undue short-term pressures on companies. These factors include, inter alia, shareholder activism, short-selling, securities lending and algorithmic and high-frequency trading. However, having analysed them, *ESMA has not considered it appropriate to make any additional policy recommendation at this stage.*

Link of interest:

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