

Report

Undue short-term pressure on corporations

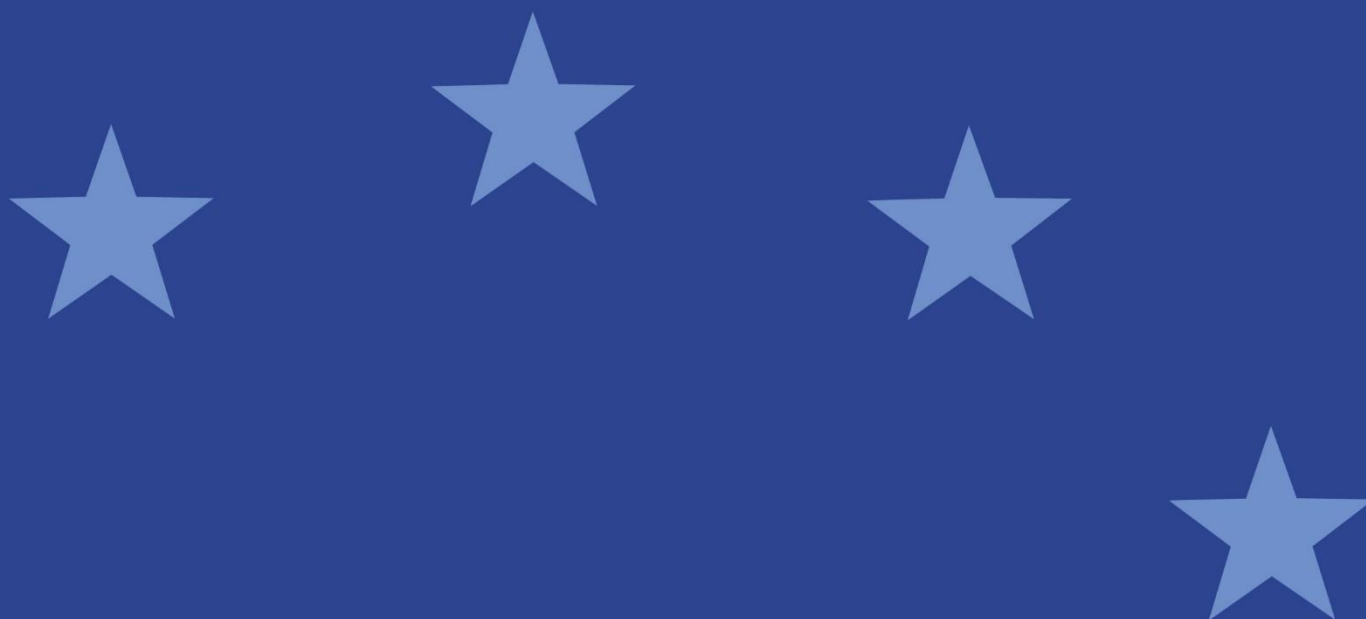


Table of contents

Acronyms and definitions	4
Executive summary	9
1. Introduction.....	12
1.1. Background.....	12
1.2. Mandate.....	12
1.3. Methodology	13
1.3.1. Selection of topics.....	13
1.3.2. Collection of evidence	14
2. Advice	16
2.1. Investment strategy and investment horizon	16
2.1.1. Evidence	16
2.1.2. Analysis	21
2.1.3. Advice	23
2.2. ESG disclosure	23
2.2.1. Existing regulatory framework	23
2.2.2. Evidence	24
2.2.3. Analysis	34
2.2.4. Advice	38
2.3. Fair value	39
2.3.1. Existing regulatory framework	39
2.3.2. Evidence	40
2.3.3. Analysis	50
2.3.4. Advice	52
2.4. Institutional investor engagement.....	53
2.4.1. Existing regulatory framework	53
2.4.2. Evidence	54
2.4.3. Analysis	66
2.4.4. Advice	70

2.5. Remuneration of fund managers	71
2.5.1. Existing regulatory framework	71
2.5.2. Evidence	72
2.5.3. Analysis	77
2.5.4. Advice	79
2.6. Remuneration of directors in listed companies	79
2.6.1. Existing regulatory framework	79
2.6.2. Evidence	80
2.6.3. Analysis	86
2.6.4. Advice	88
2.7. Use of CDS by investment funds	89
2.7.1. Existing regulatory framework	89
2.7.2. Evidence	89
2.7.3. Analysis	93
2.7.4. Advice	94
2.8. Other topics	94
2.8.1. Evidence	94
2.8.2. Feedback	97
Annex I: Call for Advice from the European Commission	104
Annex II: Papers used for literature review	107
Annex III: Questions from ESMA's public survey	124
Annex IV: Respondents to ESMA's public survey	147
Annex V: Advice from the MSG	151

Acronyms and definitions

Accounting Directive	Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC
AGM	Annual General Meeting
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD / Alternative Investment Fund Managers Directive	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
ANC	Autorité des normes comptables (France)
CDS	Credit Default Swap
CDSB	Climate Disclosure Standards Board
CFD	Contracts for Differences
Commission	European Commission
Commission Delegated Regulation (EU) 2019/356	Commission Delegated Regulation (EU) 2019/356 of 13 December 2018 supplementing Regulation (EU) 2015/2365 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of securities financing transactions (SFTs) to be reported to trade repositories
CRD	Corporate Reporting Dialogue
CSR	Corporate Social Responsibility
EFRAG	European Financial Reporting Advisory Group

EIOPA	European Insurance and Occupational Pensions Authority
Eligible Assets Directive	Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions
ELTIF	European Long-Term Investment Fund
ELTIF Regulation	Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds
EMIR / European Market Infrastructure Regulation	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
ESA	European Supervisory Authorities
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
ESRB	European Systemic Risk Board
ETF	Exchange-Traded Fund
FVOCI	Fair Value recorded through Other Comprehensive Income
FVPL	Fair Value Profit or Loss
GAAP	Generally Accepted Accounting Principles
GRI	Global Reporting Initiative

HFT	High Frequency Trading
HLEG	High-Level Expert Group on Sustainable Finance
IAS	International Accounting Standards
IAS Regulation	Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards
IASB	International Accounting Standards Board
IASB Conceptual Framework	Conceptual Framework for Financial Reporting (revised March 2018)
IFRS	International Financial Reporting Framework
IIRC Reporting Framework	International Integrated Reporting Framework (December 2013)
KPI	Key Performance Indicator
MAR / Market Abuse Regulation	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
NAV	Net Asset Value
NCA	National Competent Authority
NFRD / Non-Financial Reporting Directive	Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and

	diversity information by certain large undertakings and groups
OCI	Other Comprehensive Income
OTC	Over The Counter
P&L	Profit & Loss
PEPP	Pan-European Personal Pension product
PRI	Principles for Responsible Investment
PRIIPs	Packaged Retail Investment and Insurance Products
PRIIPs Regulation	Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs)
RHP	Recommended Holding Period
SASB	Sustainability Accounting Standards Board
SEC	Securities and Exchange Commission
SFDR / Sustainable Finance Disclosure Regulation	Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector
SFTR / Securities Financing Transactions Regulation	Regulation 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse (SFTR)
SME	Small and Medium-sized Enterprises
SMSG	Securities and Markets Stakeholder Group
SRD / Shareholder Rights Directive	Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies
SRDII / revised Shareholder Rights Directive	Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement

SSR / Short Selling Regulation	Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps
TCFD	Task Force on Climate-related Financial Disclosures
TD / Transparency Directive	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC
Takeover Bids Directive	Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids
UCITS	Undertakings for the Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
UCITS KIID	UCITS Key Investor Information Document

Executive summary

Reasons for publication

Under the Action Plan 'Financing Sustainable Growth', in the beginning of 2019 the European Commission (Commission) invited the three European Supervisory Authorities (ESAs) to each develop a report presenting evidence and possible advice on potential undue short-termism. In its call for advice (see Annex I), the Commission asked the three ESAs to investigate potential sources of undue short-termism on corporations from the financial sector and provide advice on areas which regulators should address.

To this end, ESMA conducted a financial literature review, published a survey, consulted its Securities and Markets Stakeholders Group (MSG) and hosted a stakeholder workshop to collect information on market practices and the views of financial market participants. This report summarises the evidence collected from these activities and sets out ESMA's advice to the Commission.

Content

Chapter 1 is introductory, providing background information on the Commission's call for advice and ESMA's methodology in collecting evidence for the development of this advice, including how ESMA preselected a number of topics for the focus of its advice.

Chapter 2 sets out the main content of the report and contains sections on all the topics preselected by ESMA as well as a section covering input received in relation to other topics. To the extent applicable, the sections all follow the same structure, namely a description of the existing regulatory framework in the relevant area, a summary of the evidence ESMA collected (literature review, public survey, MSG advice and stakeholder workshop), ESMA's analysis of the evidence and finally ESMA's advice to the Commission.

In particular, section 2.1. summarises input concerning investment strategy and investment horizon. ESMA covered these topics in its public survey in order to get a better understanding of investor priorities between long- and short-term values in their investment activities and potential drivers of short-termism along the investment value chain. It is noteworthy that, while stakeholders in general considered a long-term investment horizon to be longer than six years, this element was not reflected in the responses which indicated that the most common time horizon for general business activities was less than five years. In addition, a general short-term focus in investment research was indicated by survey respondents. To address the perception of short-termism in investment research, ESMA recommends that the Commission should monitor whether the integration of sustainability risks and factors by insurance companies, asset managers and investment firms helps deliver greater focus on long-term risks in investment research. ESMA also recommends that the Commission should consider, in its ongoing work on the evaluation of the MiFID II research framework, that ESMA's findings show that sell-side research is a key driver of short-termism.

Section 2.2. analyses findings on the ability of ESG disclosure to support investors in taking long-term investment decisions. Feedback across various sources shows that certain improvements are needed to ensure a minimum level of comparability, relevance and reliability of current ESG disclosures. On this basis, ESMA recommends the Commission to consider appropriate amendments to the Non-Financial Reporting Directive (NFRD). Firstly, ESMA suggests that the Commission should – as an intermediate step before a more complete, international harmonisation can be achieved – adopt delegated acts to specify key general principles for high-quality non-financial information and to establish a limited set of specific disclosure requirements. As a medium-term objective, ESMA recommends that the Commission pursues the objective of promoting the adoption on an international set of ESG disclosure standards. Secondly, ESMA proposes that the Commission should consider requiring the inclusion of the non-financial statement in the annual financial report and mandating assurance on the content of the non-financial statement as well as its consistency with other information in the annual financial report. Thirdly, ESMA advises the Commission to establish the necessary coordination between the NFRD and the Transparency Directive.

Section 2.3. summarises findings on how fair value may impact the capacity of financial reporting to provide relevant and reliable information on equity instruments held for long-term investment purposes. Neither the public survey, nor the collection of evidence from literature have highlighted that fair value measurement results in distortions of the investment process that trigger undue short-term pressures in financial markets. Fair value is deemed to be a relevant measurement basis for both managers and investors, and there is no evidence (or at least, no evidence yet) on the consequences of the implementation of IFRS 9 on long-term investment practices. This lack of evidence may also be due to the recent application of IFRS 9 by most issuers in Europe. Moreover, it was highlighted that the selection of investment horizons does not depend fundamentally on fair value measurement for equity and equity-like instruments as provided for in IFRS 9. ESMA therefore considered that on the basis of the evidence collected, no need for amending the existing requirements for fair value measurement has been identified to address concerns with undue short-termism.

Section 2.4. covers the area of institutional investor engagement and analyses how this can contribute to the long-term value maximisation of investee companies. Based on its findings, ESMA recommends that the application of the revised Shareholder Rights Directive (SRD II) is appropriately monitored in order to assess whether it effectively encourages long-term engagement, especially in certain areas. Further, to facilitate collective engagement, ESMA proposes a review of ESMA's public statement on shareholder cooperation and acting in concert under the Takeover Bids Directive.¹ ESMA also recommends the Commission to consider whether a vote on the non-financial statement could serve as an effective tool for investors to voice any concern they might have on the way investee issuers approach sustainability risks. Lastly, ESMA proposes that the impact of incentives provided under

¹ [ESMA31-65-682 Public statement *Information on shareholder cooperation and acting in concert under the Takeover Bids Directive*, 8 February 2019](#)

national laws for the promotion of shareholders' long-term perspective – such as increased voting rights – be evaluated.

Section 2.5. summarises findings on the impact on undue short-termism of remuneration policy and remuneration practices of fund managers. In general, stakeholder input indicated that due to the substantial remuneration rules for investment funds which have been put in place in recent years, immediate legislative action is not warranted in this area. However, ESMA notes that the effect of the new Sustainable Finance Disclosure Regulation should be monitored.

Section 2.6. analyses remuneration of corporate directors and summarises findings on the impact of remuneration packages on directors' incentives to pursue short- or long-term performance. On this topic, the recent revisions of the regulatory framework clearly recognise the importance of improving disclosure and investors' monitoring of remuneration, including in connection to financial and non-financial performance criteria. As a further step, ESMA recommends that the Commission – in the context of its the draft guidelines for the standardisation of the remuneration report under SRD II – further develops the standardised presentation of variable remuneration and performance targets to accommodate ESG criteria. In addition, ESMA suggests that the Commission closely monitors the implementation and effectiveness of its guidelines and considers the use of other tools should the guidelines fail to bring about the envisaged level of convergence. Finally, to ensure the quality of information disclosed in remuneration reports, ESMA proposes that the Commission should consider requiring Member States to have an adequate independent monitoring framework in place.

Section 2.7. analyses findings on the use of credit default swaps by investment funds. On this topic, the small number of respondents to ESMA's public survey does not allow for robust conclusions. ESMA will, however, continue monitoring this issue from a financial stability and investor protection perspective.

Lastly, section 2.8. summarises stakeholder input on miscellaneous topics which were not included in ESMA's preselected topics to be covered. These topics include, inter alia, shareholder activism, short selling and securities lending and algorithmic and high frequency trading. ESMA takes note of these topics, however, it does not see a solid basis for additional policy recommendations at this stage.

Next steps

This report will be delivered to the Commission and published on ESMA's website.

1. Introduction

1.1. Background

1. In its Action Plan on Financing Sustainable Growth, the European Commission (Commission) includes fostering transparency and long-termism in financial and economic activity as one of its three main aims. The Commission observes that sustainability and long-termism are inextricably linked, as investments in environmental and social objectives require a long-term orientation. However, current market practices often prompt market participants to focus on short-term performance rather than mid- to long-term objectives. It is therefore a central aspect of the sustainability agenda to reduce the undue pressure for short-term performance in financial and economic decision-making so that investors are able to make informed and responsible investment decisions.²

1.2. Mandate

2. On 4 February 2019, the Commission sent a call for advice (see Annex I) to the European Supervisory Authorities (ESAs), requesting them to collect evidence of undue short-term pressure from the financial sector on corporations and consider, if necessary, further steps based on such evidence. The aim of this request is to implement Action 10 of the Commission's Action Plan on Financing Sustainable Growth, building upon recommendations presented in the final report of the High-Level Expert Group on Sustainable Finance (HLEG).³
3. In its call for advice, the Commission invited the ESAs to assess, based on qualitative and, if feasible, quantitative evidence, whether there are practices that generate undue short-term pressure within their remit and summarise these findings in their reports. The Commission also encouraged the ESAs to engage with the most relevant stakeholders beyond the supervised entities.
4. The call for advice invited the ESAs to follow four steps in order to fulfil their mandate:
 - Collect initial evidence of undue short-termism within their respective remits;
 - Assess possible drivers of undue short-termism;
 - Identify areas in existing regulations which contribute to mitigating undue short-termism and identify areas where the rules exacerbate short-term pressures;

² [Action Plan: Financing Sustainable Growth, COM\(2018\) 97 final, 8 March 2018](#)

³ [Financing a sustainable European Economy, Final Report 2018 by the High-Level Expert Group on Sustainable Finance](#)

- On the basis of the evidence, provide policy recommendations in specific areas.
5. The mandate also set out a number of principles which the ESAs should follow when developing the reports. In particular, the ESAs were asked to act in an autonomous manner, consider reliable qualitative and quantitative data in their assessment of short-term pressures, justify their recommendations and closely coordinate their work so that the reports complement each other.
 6. The call for advice asked the ESAs to deliver their reports by the end of 2019.

1.3. Methodology

1.3.1. Selection of topics

7. In developing its advice to the Commission, ESMA established the following criteria for selecting the topics to address:
 - The advice should focus on areas within ESMA's remit;
 - The advice should address a limited number of topics to allow ESMA to undertake a thorough analysis and as such provide robust, well-corroborated and detailed advice;
 - The development of the advice should be approached with a pragmatic mindset as pointed out by the Commission in its letter to the ESAs;
 - Areas where the academic evidence is not sufficient to facilitate the Commission's request of a methodologically robust input should be excluded from the advice;
 - The advice should prioritise areas where policy recommendations are likely to have the largest value to the co-legislators;
 - The advice should be substantiated by feedback from stakeholder outreach.
8. Based on these criteria, ESMA undertook a preliminary review of relevant financial literature and identified a number of areas in which it considered that additional investigation was warranted to substantiate their relevance to undue short-termism. These areas were:
 - Investment strategy and investment horizon;
 - Contribution of disclosure of Environmental, Social and Governance (ESG) factors to long-term investment strategies;
 - Role of fair value in better investment decision-making;
 - Institutional investor engagement;

- Remuneration of fund managers and corporate executives; and
- Use of Credit Default Swaps (CDS) by investment funds.

9. The last topic was added to the survey in order to provide context to the other areas.

1.3.2. Collection of evidence

10. In each of the abovementioned areas, ESMA undertook a detailed review of the financial literature and furthermore collected evidence from market stakeholders to shed light on the dynamics at play. The evidence collected furthermore aimed at identifying any additional areas with relevance to undue short-termism.

Public survey

11. A public survey was conducted between 24 June and 29 July 2019.⁴ ESMA invited in particular 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 provide input on the six areas identified and put forward any additional topics and considerations which they considered relevant to short-termism.
12. More than 90 stakeholders provided input to the survey.⁵ Around half of respondents requested that their response not be published, whereas the other half of responses are published on ESMA's website.⁶ Both published and unpublished responses were taken into account in ESMA's analysis and are referred to in this report.
13. Table 1 below sets out the type of respondents, based on self-classification. While 48% of respondents selected the option 'Other' to identify themselves, for the purposes of its report, ESMA re-classified some of these respondents to be able to draw meaningful conclusions from its analysis.

Table 1: Classification of respondents by type

<i>Type of respondent</i>	<i>Number</i>	<i>Proportion</i>
Investor	35	40.7%
Investor association	13	15.1%
Issuer association	12	14.0%
Issuer	9	10.5%

⁴ [News Item ESMA consults on short-termism in financial markets, 24 June 2019](#)

⁵ Eighty-six stakeholders responded to the individual survey questions while six stakeholders provided input without responding to the individual survey questions.

⁶ [News Item ESMA published responses to survey on short-termism in financial sector, 5 September 2019](#)

Exchange or trading system	3	3.5%
Other	3	3.5%
Investment analyst	2	2.3%
Investment intermediary	2	2.3%
Legal, accountancy and actuarial	2	2.3%
Non-Governmental Organisation	2	2.3%
Credit Rating Agency	1	1.2%
Investment intermediary association	1	1.2%
Standard setter	1	1.2%

14. The vast majority of respondents (75%) identified the financial sector as their industry, while 18% of respondents selected the option 'Other'. Furthermore, 64% of respondents specified that they did not represent an association. Respondents' self-identified country of affiliation is reflected in Table 2 below:

Table 2: Classification of respondents by country

<i>Country</i>	<i>Number</i>	<i>%</i>	<i>Country</i>	<i>Number</i>	<i>%</i>
Austria	3	3.5%	Luxembourg	3	3.5%
Belgium	5	5.8%	Netherlands	2	2.3%
Bulgaria	13	15.1%	Norway	1	1.2%
Croatia	4	4.7%	Portugal	2	2.3%
Cyprus	1	1.2%	Slovakia	3	3.5%
France	12	14.0%	Slovenia	1	1.2%
Germany	6	7.0%	Spain	3	3.5%
Italy	3	3.5%	Sweden	2	2.3%
Latvia	1	1.2%	United Kingdom	8	9.3%

Lithuania	1	1.2%	Other	12	14.0%
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Securities and Markets Stakeholder Group

15. Furthermore, in accordance with its founding Regulation (EU) No 1095/2010 (the ESMA Regulation), ESMA sought the input of the Securities and Markets Stakeholders Group (SMSG). The input provided by the SMSG is summarised within each relevant section of the report and presented in full in Annex V.

Stakeholder workshop

16. Lastly, ESMA hosted a stakeholder workshop on 16 September 2019 with the aim to present the feedback received to the public survey and to exchange views with financial market participants regarding possible recommendations to the Commission. Participants in the workshop were representatives of investors, issuers, asset managers, asset owners and academics. The feedback from workshop participants is summarised within each relevant section of the report.

2. Advice

17. This chapter contains eight sections, one dedicated to each of the areas which ESMA has pre-selected and one section summarising the input that ESMA received on additional topics.
18. Where relevant, the sections start by setting out an overview of the current regulatory framework in the area to provide background and context. This is followed by the evidence ESMA collected from the literature review, the public survey, the SMSG and the stakeholder workshop. The collective evidence in each area is then analysed and the main takeaways are distilled.

2.1. Investment strategy and investment horizon

19. In order to put the issue of short-termism in context, ESMA included a series of questions in the public survey on investment strategy and investment horizons pursued by financial institutions, including on general business time frames and investor holding periods. Responses to these questions were valuable inputs to ESMA as they formed the backdrop to the other sections and raised interesting issues on the notions of short- and long-term.

2.1.1. Evidence

Literature review

20. The purpose of the questions on investment strategy and investment horizon was to get a broad understanding of how investors prioritise short- and long-term values in their

investment activities. Hence, ESMA did not conduct a separate literature review on this topic.

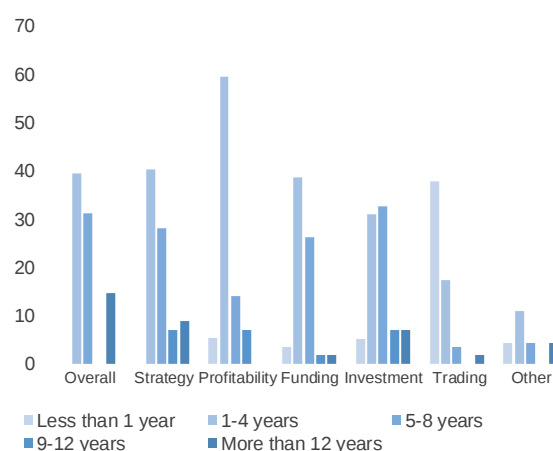
Public survey

21. Respondents were asked to provide general feedback on the key features and focus of their investment strategies as well as on their investment time horizon. The underlying assumption was that long-term investment projects can support the shift towards a more sustainable financial and economic system.

Questions 7 - 8

22. Eighty-six respondents answered question 7 on what time frame is considered to define long-term investment. 27% of respondents (23) picked 6-10 years while 24% of respondents (21) chose 11-30 years. In other words, over half of respondents believed that an investment period is defined as long-term when it covers at least a 6-year horizon. 35% of respondents (30) chose “Other”, often citing the difficulty of defining long- or short-term.

Table 3
Applicable time horizons to business activities

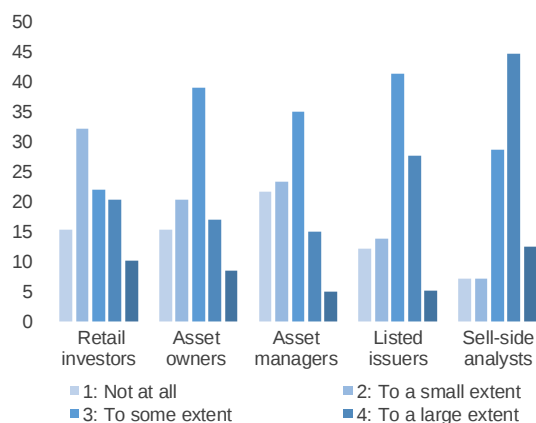


Note: Time horizon applicable to business activities (Q8), %
Sources: Public Consultation ESMA

23. However, when responding to question 8,⁷ which asked respondents to indicate the time horizon that is applied in relation to business strategy, profitability, funding and trading, the most common answer by almost 40% of respondents (19) was 1-4 years, while close to 60% of respondents (34) chose this time period in relation to profitability. At the same time, 31% of respondents (15) indicated that the time horizon they apply in their overall business activities is between 5 and 8 years.

⁷ Between 58 and 46 respondents responded to question 8.

Table 4
Investment value chain nodes



Note: Nodes in the investment value chain contributing to the tendency towards short-termism (Q9), %
Sources: Public consultation ESMA

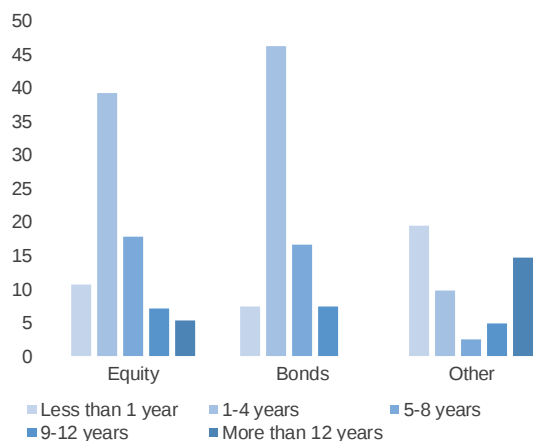
Questions 9 - 10

24. In response to question 9 regarding which node in the investment value chain contributes most to the tendency of short-termism, 45% of respondents (25) considered that sell-side analysts contribute to short-term investment behaviour to a large extent. Smaller proportions of the respondents considered that other financial market participants contribute to a large (or a great) extent to the tendency towards short-termism, notably top managers of listed issuers (28% - 16 respondents), retail investors (20% - 12 respondents), asset owners (17% - 10 respondents) and asset managers (15% - 9 respondents).

25. Furthermore, one respondent noted that internal conflicts of interest within the sell-side can hinder analysts from producing more in-depth long-term oriented research. The same respondent noted that the rules on investment research under Directive 2014/65/EU (MiFID II) correctly address this issue and are a step in the right direction to allow sell-side research to consider long-term, wider sustainability issues.
26. In response to question 10, which asked respondents to which extent certain factors result in short-termism in their own institutions, no single factor stood out. Instead, respondents mentioned several factors that contribute to short-termism to some extent, including client demand (35% - 18 respondents), market pressures (31% - 16 respondents) and competitive pressure (30% - 16 respondents). On the other hand, 44% of respondents (23) considered that executive management remuneration does not result in short-termism by their institution, while 21% of respondents (11) were of the view that executive remuneration is a driver of short-termism by their institution but only to a small extent. Furthermore, 42% of respondents (22) were of the view that the macroeconomic environment contributes to short-termism by their institution to a small extent and 22% of respondents (12) did not consider that this factor had a relevance for short-termism by their institution.

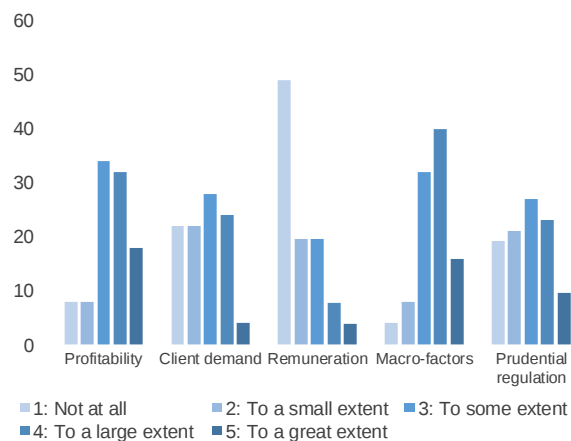
Questions 11 - 12

Table 5
Holding period



Note: Actual holding period prevailing in the investment strategy (Q11), %
Sources: Public consultation ESMA

Table 6
Factors driving actual holding period

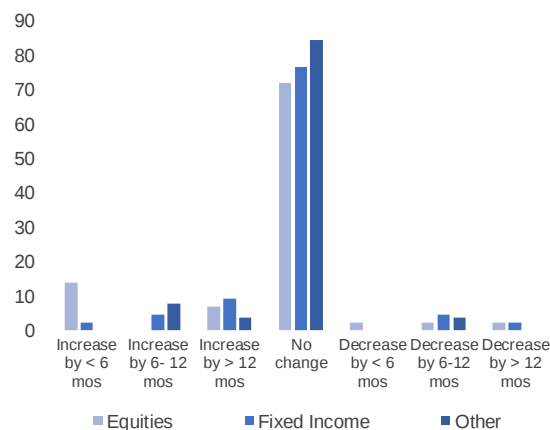


Note: Impact of identified factors in modifying the holding period (Q12), %
Sources: Public Consultation ESMA

27. Moving to the topic of the holding period, in response to question 11, 50% of respondents (28) indicated that the holding period for equities is most commonly less than 5 years, while 13% (7 respondents) apply a holding period that is longer than 9 years. Similarly, the holding period for bonds is less than 5 years for 54% of respondents (29), while only 7% of respondents (8) apply a period longer than 9 years.
28. In response to question 12, which asked which factors drive the actual holding period, 40% of respondents (20) indicated that monetary policy and macroeconomic factors drive holding periods to a large extent while 16% of respondents (8) considered this factor as relevant to a great extent. Other factors were also considered to drive the actual holding period to a large extent, such as profitability (32% - 16 respondents), client demand (24% - 12 respondents) and prudential regulation (23% - 12 respondents), while a few respondents selected these factors as drivers of the actual holding period to a great extent, notably profitability (18% - 9 respondents), client demand (4% - 2 respondents) and prudential regulation (9% - 5 respondents). Conversely, 49% of respondents (25) considered that remuneration practices in the financial sector are not at all a driver of actual holding periods and 20% of respondents (10) were of the view that remuneration was a driver of the holding period to a small extent.

Questions 13 - 14

Table 7
Expected evolution of average holding period



Note: Expected evolution in the average holding period for equity, fixed income, and other portfolios (Q13)
Sources: Public Consultation ESMA

29. Regarding question 13, which asked respondents how they expect their holding periods to change in the next two years, the response was overwhelmingly that no notable change was expected (72% - 31 respondents for equities and 77% - 33 respondents for fixed income).

30. Furthermore, in response to question 14, more than one third of respondents indicated that mainly the same factors which drive the actual holding period are also expected to have an impact on its future change. As such, monetary policies / macroeconomic factors and profitability are to a large or a

great extent expected to drive evolution in the expected holding period for both equities and bonds.

31. Lastly, it was observed that a low portfolio turnover is not in itself an indicator of long-term investment and, therefore, focusing on the holding period may be disputable. Also, an issuer association flagged that certain factors, such as market benchmarks, can contribute to shorter-term outlooks, while an investor association mentioned that the current use of benchmarks to assess portfolio managers' performance may be a driver of short-termism. On that basis, this stakeholder suggested introducing in the Regulation (EU) No 1286/2014 (PRIIPS Regulation) KID the long-term performance disclosure requirements that are in the Directive 2009/65/EC (UCITS Directive) KIID, which provides the long-term performance of the benchmark.

Advice from the SMSG

32. The SMSG advice pointed out that investment funds offer a wide range of different risk profiles and time horizons in order to match different investor demand for the investment horizon and risk appetite. The SMSG, furthermore, mentioned that 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.

Stakeholder workshop

33. Stakeholders welcomed ESMA's presentation of the results of the public survey on investment strategies and investment horizon.⁸ Participants discussed the role of ESG, the investment ecosystem and green finance and underlined the importance of sustainable finance and ESG in fostering long-termism in investment strategies and investment horizons. Participants made a number of suggestions regarding areas which ESMA should also consider in its advice:
- Definition of 'short-term time horizon' to put more context around holding periods and portfolio turnover;
 - Role of activist investors which in some cases may be a driver of undue short-termism;
 - Role of disclosure obligations to clients when the value of a portfolio decreases by 10%.

2.1.2. Analysis

34. ESMA observes that half of the respondents indicated that they generally consider a long-term investment period to be longer than six years whereas the most common time horizon for general business activities was indicated as less than five years. In this light, it is also noteworthy that the most commonly reported answer for average holding period for both equities and bonds was one to four years, with little expectation of changing holding periods in the next two years.
35. In general, the input provided in relation to holding periods and business horizons does not, in ESMA's view, seem to provide the basis for further policy initiatives, as it only offers a snapshot mapping of current market practices without historical comparison. In addition, ESMA underlines that feedback to the public survey emphasised the importance of economic activities and monetary policies / macroeconomic factors for the investment holding period, elements which are not easily influenced by policy-based initiatives.
36. Furthermore, regarding the role of portfolio turnover, ESMA believes the rules being implemented in Directive (EU) 2017/828 (the revised Shareholder Rights Directive or SRD II) could improve transparency around portfolio turnover. While asset managers must report on portfolio turnover and turnover costs to their institutional investor clients, institutional investors must report how they monitor turnover costs and how they define and monitor a targeted portfolio turnover or turnover range with their asset managers. ESMA is of the view that a focus on costs of turnover and turnover ranges could lead to longer holding periods generally.

⁸ Please find the presentations [here](#) and [here](#).

37. However, ESMA notes that a significant number of respondents considered sell-side analysts as drivers of short-termism, choosing this node in the investment chain as the one that contributes most to short-termism. ESMA understands that this finding may indicate a general short-term focus in investment research.
38. ESMA believes that development of long-term financial analysis is hampered by (i) the shortage of relevant data from issuers with company disclosures focusing on the short term and (ii) the lack of demand from the buy-side as investors tend to trade their assets with short-term horizons. In this respect, ESMA notes that:
- With regards to data availability, the planned improvements in ESG disclosures (see relevant sections of this report) can help counter undue short-termism in financial markets by complementing the information provided through traditional financial metrics with information on how issuers manage ESG factors that typically affect a company's future resilience and ability to create value for stakeholders;
 - With regards to buy-side demand, ESMA notes the role of the measures on clarifying institutional investors' and asset managers' duties in relation to sustainability risk which the Commission intends to adopt under Action 7 of its Action Plan on Financing Sustainable Growth. Following advice issued by ESMA and EIOPA in April 2019,⁹ these measures should clarify how asset managers, insurance companies and investment or insurance advisors should integrate sustainability risks and, where relevant, other sustainability factors in the areas of organisational requirements, operating conditions, risk management and target market assessment. ESMA believes that by integrating sustainability risks, these financial market participants will also place greater value on long-term investment research.
39. Overall, ESMA believes that both these elements should help address the current short-term focus of financial analysts that was highlighted by respondents to the public survey.
40. As noted in paragraph 319 below, the Commission is in the process of reviewing certain aspects of the functioning of the MiFID II research framework. ESMA therefore suggests that the Commission may wish to consider this particular finding of the survey regarding sell-side analysis for its work in this area.

⁹ [ESMA35-43-1737 Final Report ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II, 30 April 2019](#); [ESMA34-45-688 Final Report ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD, 30 April 2019](#); [EIOPA-BoS-19/172 EIOPA's Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, 30 April 2019](#)

41. Lastly, the suggestions on areas that should be covered in ESMA's advice raised by participants to the stakeholder workshop are addressed in section 2.8.2. of this report.
42. As regards the comment on the potential short-term effect of the use of benchmarks to measure performance, ESMA notes that there are legitimate investor protection reasons to assess the performance of asset managers against market benchmarks as it allows investors to compare the performance of their collective portfolio management options. In this context, the UCITS KIID requires the disclosure of the reference benchmark as well as its historical performance to the end investor. ESMA observes that this requirement is driven by investor protection concerns which outweigh the potential short-term impact.

2.1.3. Advice

43. On the basis of the above considerations, ESMA presents its advice to the Commission below.

ESMA recommends the Commission to:

- (a) Monitor whether the integration of sustainability risks and factors by asset managers, insurance companies and investment or insurance advisors helps deliver greater focus on long-term risks in investment research.
- (b) Consider, as part of its work on the functioning of the MiFID II research framework, that in the answers provided to ESMA's survey, a significant number of respondents considered sell-side analysts as drivers of short-termism, choosing this node in the investment chain as the one that contributes most to short-termism.

2.2. ESG disclosure

2.2.1. Existing regulatory framework

44. In 2013, the Commission proposed new requirements in relation to disclosure of non-financial and diversity information by certain large EU companies and groups. The legislative proposal was based on an acknowledgement of the fact that *"only a limited number of EU large companies regularly disclose[d] non-financial information, and the quality of the information disclosed varie[d] largely, making it difficult for investors and*

stakeholders to understand and compare companies' position and performance".¹⁰ It aimed to deliver on one of the main commitments of the Commission's 2011-2014 strategy for Corporate Social Responsibility.¹¹

45. On this basis, in 2014 the EU adopted Directive 2014/95/EU (the Non-Financial Reporting Directive or NFRD), an amendment to Directive 2013/34/EU (the Accounting Directive). The NFRD requires large public-interest companies with more than 500 employees (for example listed companies, banks and insurance companies) to disclose information on the way they operate and manage social and environmental challenges, generally referred to as non-financial information.
46. More specifically, the NFRD requires the abovementioned companies to publish reports on the policies they apply as regards environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery matters. Where a company does not pursue policies in relation to one or more of these areas, it is required to provide an explanation for not doing so.
47. The NFRD allows companies to disclose their non-financial information in the way which they consider best suited to their situation. As such, companies may include their non-financial information in an annual non-financial statement to be presented either in the management report or in a separate document. Companies may base their disclosure on national, European or international guidelines. The Commission published non-binding guidelines on non-financial reporting¹² in 2017 which were complemented with further content regarding climate-related reporting¹³ in June 2019.
48. The requirements of the NFRD had to be applied for financial years starting during the calendar year 2017. As such, the first mandatory disclosure of non-financial information under the NFRD was published in 2018, and a second cycle of disclosure was published in the beginning of 2019.

2.2.2. Evidence

Literature review

49. The public debate around short-termism frequently points at disclosures of sustainability and ESG disclosures as an area which can contribute to relieving the pressure for corporates and financial institutions to deliver short-term financial results, thus enabling investors to take a longer-term approach. For example, in its Final Report the HLEG

¹⁰ [Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups, COM\(2013\) 207 final, 16 April 2013, page 2](#)

¹¹ [Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A renewed EU strategy 2011-2014 for Corporate Social Responsibility, COM\(2011\) 681 final, 25 October 2011](#)

¹² [Communication from the Commission – Guidelines on non-financial reporting \(methodology for reporting non-financial information\), C/2017/4234, 5 July 2017](#)

¹³ [Communication from the Commission – Guidelines on non-financial reporting: Supplement on reporting climate-related information, C/2019/4490, 20 June 2019](#)

suggested that a stronger company focus on issues and metrics that are relevant to the long-term success of the business would support sustainability and a long-term orientation of market participants (2018).

50. In this respect, it has been highlighted that short-termism constitutes a ‘vicious cycle’ in which the setting of short-term goals and metrics by companies in response to investor demand further contributes to shorten investors’ horizons (Barton et al. 2016). A frequently cited reason for this vicious cycle is the fact that stock markets make forecasts of firm value based on companies’ reported earnings, thus introducing a short-term or myopic incentive in company behaviour (Stein 1989). Similarly, some have referred to a ‘perfect storm’ (2°Investing Initiative 2017) to describe a situation in which factors such as relatively flexible regulatory requirements, a race to the bottom among peer companies, a limited role of auditors, the fear of litigation and limited demand from financial analysts discourage long-term risk disclosures, thus fostering short-termism.
51. In order to lessen some of the pressure for short-termism in financial markets, it has been suggested that the quality of the investor-corporate dialogue needs to be more long-term oriented (Principles for Responsible Investment and UN Global Compact 2017).¹⁴ From this perspective, the disclosure of appropriate non-financial measures constitutes an important element to complement traditional financial measures (Barton 2017). The recent increase in stakeholder scrutiny of ESG matters, including by institutional investors (Share Action 2019), and companies’ growing awareness of the risks and opportunities associated with ESG issues, confirm the importance of these aspects (IIRC et al. 2019).¹⁵ Particularly, as of 2018, 1,950 organisations with almost USD 90 trillion in assets under management were signatories to the Principles for Responsible Investment, indicating a growing commitment by investors to incorporate sustainability issues into investment analysis and decision-making. ESG factors seem to also increasingly influence the allocation and monitoring of assets at major institutions, as highlighted by Deutsches Aktieninstitut & Rothschild & Co Deutschland (2018).¹⁶
52. However, existing literature has identified a number of challenges to effective mandatory ESG disclosure, most notably the difficulty of creating standards which ensure relevant disclosure on comparable, reliable and relevant ESG information,¹⁷ the (lack of) materiality of ESG information disclosed, the use of boilerplate language as an avoidance tool and the absence of an enforcement and assurance regime for ESG

¹⁴ In this report, it is recommended that “[c]ompanies should confidently demonstrate how their business strategy, including their approach to sustainability, will create long-term value for their investors”.

¹⁵ The IIRC, the Association of International Certified Professional Accountants and Black Sun highlight that 89% of business leaders agree that their organisation need to focus on wider value considerations and 64% rate broader information considerations as extremely important.

¹⁶ Survey of 18 large institutional investors with assets under management of EUR 14.4 tn. These investors include some of the largest passive global funds, active UK, US, German, Nordic, Dutch and French long-term investors and ten of the top 20 DAX and MDAX largest investors.

¹⁷ For example, 2°Investing Initiative (2017) highlights the fact that ESG disclosure standards and practices may be mostly focused on backward-looking rather than forward-looking data.

reporting (Christensen et al. 2019). Another challenge identified relates to the risk of selection bias in the reported information (Boiral 2013).

53. These challenges and the increasing demand from investors for ESG disclosure point to a general issue of quality of the information provided by issuers (CFA Institute 2019).¹⁸ In this respect, Hope et al. (2016) underline that investors and analysts are better able to assess fundamental risk when firms' disclosures are more detailed. GRI (2016) highlight that while companies are generally good at reporting on their operational performance, investors would like to see more in-depth information, including on the strategic relevance of the topics and companies' response in this regard, e.g. the risk exposure, approach to opportunities, sustainability targets and progress towards them.
54. In assessing the quality of ESG disclosures in SEC filings, the Sustainability Accounting Standards Board (SASB) (2017) found that most sustainability disclosure consists of boilerplate language and that such vague and non-specific information is used more than 50% of the time. In addition, sustainability performance metrics are rarely disclosed, and when they are, they lack comparability. More specifically on climate-related financial disclosure, the 2019 Status Report from the Task Force on Climate-related Financial Disclosures (TCFD) highlighted that, while disclosure in this area has increased since 2016, it is still insufficient for investors. As such, more clarity is needed on the potential financial impact which climate-related issues may have on companies, and the use of scenario analysis still appears limited with too few companies disclosing information on the resilience of their strategies to climate-related risks. This evidence is broadly in line with the acknowledgment by the International Monetary Fund in its latest Global Financial Stability Report (2019) that ESG reporting is still largely inconsistent and that it would require the intervention of policymakers to set a minimum set of mandatory requirements. Similarly, the Network for Greening the Financial System (2019) called on policymakers and supervisors to consider further actions to foster the development of an internationally consistent environmental disclosure framework and broader adoption of the TCFD recommendations.
55. Looking more specifically at the ESG disclosure landscape in the EU, the experience arising from the first reporting periods highlights that there is significant room for improvement in the application of the NFRD. For example, in its 2018 report, the Alliance for Corporate Transparency found that, while the vast majority of surveyed companies acknowledged the importance of environmental and social issues for their business in their reports, in only approximately half of the cases was information on environmental matters clear in terms of concrete issues identified, targets and principal risks. More in general, most companies provided information that was considered insufficient to enable an understanding of (i) the impact of their activities on the non-financial matters required by the NFRD and (ii) the impact of the non-financial matters, for example in terms of

¹⁸ In its 2019 report, the CFA Institute indicated that 67% of survey respondents incorporate governance factors into their investment analysis and 51% incorporate environmental and social factors into their investment analysis.

risks and opportunities, on their activities. A report from the Climate Disclosures Standards Board (CDSB) and CDP (2018) based on the review of a sample of non-financial statements for the year 2017 also found significant room for improvement in the disclosure practices under the NFRD. ESMA observes that the evidence from these reports is fairly aligned with that arising from ESMA's 2018 Activity Report¹⁹ which also highlighted several areas for improvement in the disclosure of non-financial information by European issuers.

56. On the basis of the issues identified in the initial disclosure practices pursuant to the NFRD, several recommendations have been proposed by different parties to improve ESG reporting in Europe. These recommendations address specific shortcomings relating to the applicable requirements, for example improvements to the disclosure obligations for selected areas, such as environmental issues and human rights, as well as proposals to increase the degree of comparability and enable stronger enforcement (CDSB 2018; Alliance for Transparency 2019; NGFS 2019; 2° Investing Initiative 2017).
57. Other recommendations addressing the broader architecture of ESG disclosure in Europe were brought forward in a May 2019 report by Mr Patrick de Cambourg, Chair of the French accounting standard setter ANC, in response to a request from the French Ministry of Finance. This report acknowledged the current momentum surrounding 'extra-financial information' which has triggered the establishment of multiple initiatives and disclosure frameworks which, however, still lack coordination and consistency. The report put forward an approach to standardise the extra-financial information which should be provided to all corporate stakeholders to enable them to assess companies' contribution to sustainable economic, financial and social development. The report proposed that a package of legally binding measures should be pursued, based on four pillars: (i) general principles for quality and classification of information; (ii) general and sector-specific standards for the content of the disclosures; (iii) presentation principles, including a taxonomy for electronic reporting and (iv) principles for accountability, including companies' governance related to the disclosed information, external control and supervision. These initiatives should be based on a methodology including, inter alia, acting at global, European and national level and ensuring that the disclosure standards have public legitimacy. The report suggested that a European 'public sphere' organisation should be tasked with establishing the extra-financial information standards.
58. Lastly, the Corporate Reporting Dialogue (CRD)²⁰ recently published the first report summarising the outcome of its convergence project 'Better Alignment' (2019a). The project aims at exploring the alignment of five disclosure frameworks and standards with the TCFD recommendations and at communicating areas of overlap, consistency and

¹⁹ [ESMA32-63-672 Report Enforcement and Regulatory Activities of European Accounting Enforcers in 2018, 27 March 2019](#)

²⁰ The Corporate Reporting Dialogue is a platform, convened by the International Integrated Reporting Council (IIRC) and involving: CDP, Climate Disclosure Standards Board, Financial Accounting Standards Board (observer), GRI, IASB, IIRC, International Organization for Standardization, SASB.

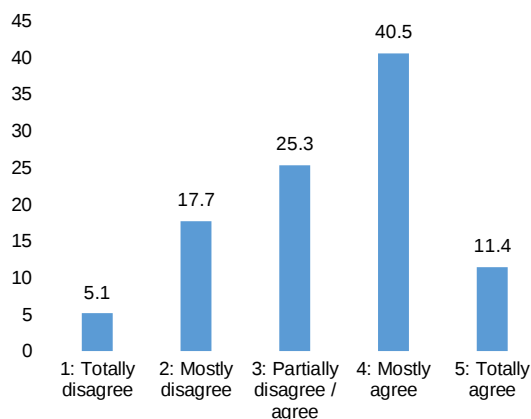
degrees of alignment with the purpose of helping companies to more effectively use the various ESG frameworks and standards to meet the TCFD recommendations. Earlier this year, the CRD also published a report (2019b) describing seven principles of transparency and accountability that member organisations of the CRD commonly believe are fundamental to corporate reporting; materiality, completeness, accuracy, balance, clarity, comparability and reliability.

Public survey

Questions 15 - 18²¹

Table 8

Does ESG disclosure enable long-term investment decisions?



Note: Replies to the question: 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? (Q15), %
Sources: Public consultation ESMA

59. Of the 79 respondents that answered question 15, 77% (including 15 UCITS management companies and 7 investor associations) acknowledged, to varying degrees, that ESG disclosure by listed companies enables investors to take long-term investment decisions. The most prevalent reasons for holding this opinion were that ESG disclosure provides insights into a listed company's long-term risk profile (46 respondents), that it complements the information provided by listed companies in their financial statements (45 respondents) and that it provides insights into a company's future financial performance (29 respondents). In the supplementary

comments, six respondents – including three investor associations – explained that standardised disclosure is key, with some respondents voicing a wish for further improvements to be made as the current use of a variety of reporting frameworks is unhelpful. The need for standardised disclosures was further emphasised by respondents in the feedback to question 59 at the end of the questionnaire.

60. While these respondents recognised the positive relationship between ESG disclosure and investors' ability to make long-term investment decisions, some of them acknowledged that there are some impediments to this relationship. In this regard, to a large or a great extent respondents believed that the following factors discourage investors from using ESG disclosure to apply a long-term investment horizon: (i) lack of sufficiently forward-looking disclosure on ESG risks and opportunities; (ii) lack of comparability between different companies' disclosure due to NFRD requirements not being sufficiently detailed and allowing use of various frameworks; (iii) lack of a clear link between ESG matters and the company's current and future performance and (iv) lack of consistency between companies' disclosed ESG policies and evidence of their actions. Certain respondents furthermore commented that ESG data quality is an issue

²¹ Question 15 asked respondents to indicate to which extent they agreed that disclosure of ESG information by listed companies enables investors to take long-term investment decisions. Question 16 asked the respondents who totally or mostly disagreed with question 15 why such disclosure does not enable investors to take long-term investment decisions. Question 17 asked respondents who totally or mostly agreed or partially disagreed and partially agreed with question 15 why such disclosure enables long-term investment, and question 18 asked the same respondents to indicate the extent to which certain factors discourage investors from using ESG disclosure to apply a long-term investment horizon.

(data is self-reported leading to low reliability and consistency; disclosure methodologies vary across data providers; data is not quantifiable).

61. 23% of respondents (18), on the other hand, either mostly or totally disagreed that ESG disclosure by listed companies enables long-term investment decisions. Respondents' reasons for holding this view were very dispersed and all of the potential impediments listed under question 16 of the questionnaire were selected by varying numbers of respondents. However, the following were the more common responses: (i) lack of a clear link between ESG matters and the current and future performance of the company; (ii) lack of sufficiently forward-looking disclosure on ESG risks and opportunities and (iii) lack of consistency between the disclosed ESG policies and evidence of the company's actions. Furthermore, individual respondents commented that the absence of standardised and comparable ESG disclosure is problematic for investors looking to pursue ESG objectives or take long-term investment decisions and that the nature of a business and its economic performance and long-term prospects rather than ESG considerations determine investors' decisions. Respondents also echoed the point mentioned in paragraph 60 that ESG data quality is an issue. Lastly, it was remarked that it is too soon to evaluate the implementation and impact of the NFRD, as further elaborated in paragraph 69.

Question 19

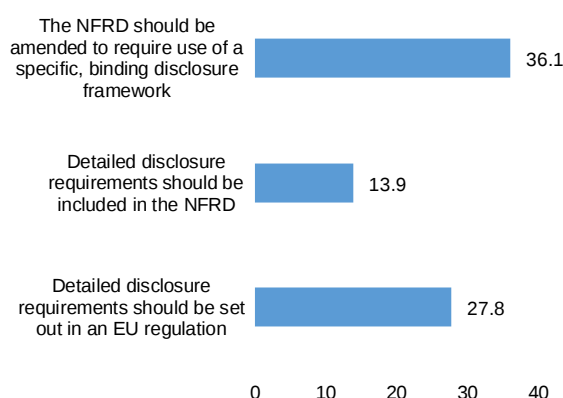
62. Of the 66 respondents to question 19, 59% considered that requiring specific disclosures on intangible assets which are not accounted for in the financial statements would enable long-term investment decisions. The main reasons provided were that intangible assets constitute an increasingly large part of company value and should as such be covered in the financial reports.
63. When asked to elaborate on the types of intangible assets that should be disclosed, the most cited asset was human capital and respondents furthermore mentioned, among other, research and development, intellectual property, natural / environmental capital and customer relations and retention rates. Some respondents remarked that relevant assets will depend on the industry and one respondent suggested that disclosure of intangibles should not be limited to assets but extended to activities as well. Lastly, it was mentioned that it is unhelpful that acquired and internally generated intangibles are disclosed together under IFRS 3 and IAS 38.
64. There was no discernible trend in responses regarding the methods of valuation that should be used, but suggestions included GAAP, IAS / IFRS and an independent assessment of a company's carbon footprint. One respondent commented that while intangible assets should be disclosed, they should not be subject to valuation.
65. On the other hand, 41% of respondents (27) considered that requiring disclosures on intangibles which are not covered in the financial statements would not enable long-term investments. Several arguments were presented by these respondents. Firstly, it was argued that the current IFRS framework provides sufficient disclosure for investors, and that the requirements should not be extended. It should, according to one respondent,

be up to financial analysts rather than the issuer itself to value intangible assets, and another respondent suggested that issuers should in any case focus more on explaining how they create long-term value for investors. Secondly, it was argued that intangible assets can only be valued with an element of subjectivity and this type of information should not be included in the financial statements.

Question 20

66. The 73 respondents to question 20 were evenly split between those who considered that further requirements are needed to increase the level of detail in the NFRD disclosure requirements on non-financial information and those who did not believe further requirements to be necessary.

Table 9
How to increase detail in disclosure requirements?



Note: Replies to the question: If you consider that further requirements are needed to increase the level of detail in the disclosure requirements regarding non-financial information, which approach is appropriate? (Q20), %
Sources: Public Consultation ESMA

detailed disclosure requirements in an EU regulation whereby the requirements would be directly applicable in all EU Member States (ten respondents), while including detailed disclosure requirements directly in the NFRD itself was a less favoured approach (five respondents).

67. Among the respondents who supported further requirements, the most cited reason was the need for further harmonisation and standardisation of companies' non-financial disclosure to enable comparison across companies and across Member States. When these respondents were asked how the level of detail in non-financial disclosure should be increased, the favoured approach was amending the NFRD to require the use of a specific, binding disclosure framework (13 respondents). The second most frequent response was establishing
68. The eight respondents who chose the response "Other" made a number of points of which the following were mentioned by more than one respondent: it is important to make the EU disclosure framework for non-financial information consistent with global frameworks such as the TCFD and the SASB, more detail could be added to the disclosure requirements in the NFRD, but some flexibility should be maintained and use of a specific disclosure framework should not be made mandatory by the NFRD.
69. Among the respondents who said that no further requirements are needed to increase the level of detail in the non-financial disclosure requirements, six stakeholders (including three issuer associations) argued that it is premature to assess whether the NFRD has brought about the necessary changes, as issuers have only had to apply it

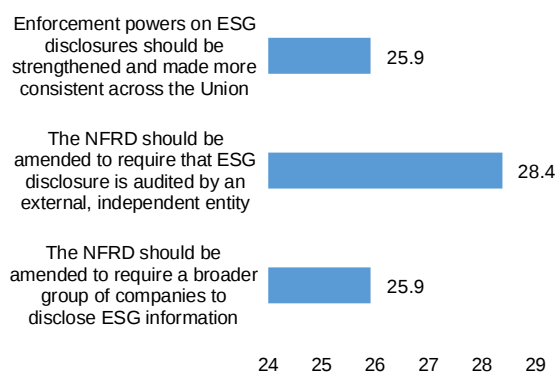
for two reporting periods. Changing the NFRD at this stage would therefore be counterproductive and burdensome for issuers who need regulatory stability. It was furthermore suggested that disclosure should be demand-driven rather than pushed through via costly regulatory requirements. Some respondents mentioned that it is not necessary to make the NFRD's disclosure requirements more detailed, since the NFRD's principle of materiality obliges issuers to assess which information should be provided to their investors and creditors. Lastly, some of the respondents who responded "No" to question 20 qualified their response by commenting that comparability of disclosure is a bigger issue than the level of detail, that it is more important to provide a conceptually robust set of principles for companies to identify what they should disclose, that it could be useful to provide more concrete guidance to companies, e.g. by updating the Commission's non-binding guidelines on social matters and other environmental issues than climate (though disclosure should be voluntary) and that consistency should be ensured with other global frameworks such as the GRI and the IIRC Reporting Framework (as also mentioned above). Some of these arguments were also reiterated by respondents providing feedback to question 60 at the end of the questionnaire.

Question 21

70. Of the 76 respondents to question 21, 60% considered that further steps in the area of non-financial reporting are needed to enable investors to take long-term investment decisions.

Table 10

Further steps to enable long-term investment decisions



Note: Replies to the question: If you consider that further steps in the area of non-financial reporting are needed at the national or European level to enable investors to take long-term investment decisions, which approach is appropriate?, (Q21), %
Sources: Public Consultation ESMA

71. These respondents were quite evenly distributed across the approaches which were proposed in the questionnaire – amending the NFRD to require that ESG disclosure be audited by an external, independent entity (23 respondents), amending the NFRD to require a broader group of companies to disclose ESG information (21 respondents), and strengthening and aligning ESG enforcement powers across the EU (21 respondents). The 16 respondents who proposed other approaches mentioned, inter alia, that the EU could be a key stakeholder in

proposing and developing international initiatives on non-financial information, focused on defining general quality principles and determining a general classification scheme for non-financial information, and that the focus could be shifted a bit from ESG disclosure to supporting the work underway in the International Accounting Standards

Board's (IASB) Management Commentary Consultative Group. Others reiterated the points summarised under question 20.

72. The respondents who did not consider that further steps in the area of non-financial reporting are needed to enable investors to take long-term investment decisions mentioned the following reasons for holding this view: (i) the current scope of the NFRD is well-balanced and appropriate as smaller companies outside the NFRD scope will still be required to provide ESG data by the large public interest entities to whom they provide goods and services; (ii) further disclosure requirements would be unhelpful and difficult for companies to comply with; it is important to maintain flexibility in disclosure requirements to cater to differences between companies and investors; a lot of disclosure is already being provided due to investor demand; (iii) it is too soon to assess whether the NFRD has brought about the necessary changes, as issuers have only had to apply it for two reporting periods, and as investors need time to incorporate the new disclosure into their decision making; (iv) ESG information is not as important as financial information; focus should be on financial information; (v) action should be supported at the international rather than the European level, and Europe should help drive the agenda and (vi) EU policy should focus on creating incentives for investors to select investments with a long-term horizon and taking into account ESG factors; in doing so, it is important to be aware of the short-term bias of sell-side analysts due to commercial conflicts. Comments regarding the need for international rather than European-only standards were also included in response to question 60 which asked respondents for their broader considerations on short-termism.

Advice from the SMSG

73. The SMSG observed that there is uncertainty about the concepts and legal framework of Corporate Social Responsibility (CSR) reporting and that most reporting frameworks fail to establish methodologies for assessing CSR performance. This leads to shortcomings in the quality, accuracy, availability and comparability of CSR data. Furthermore, the SMSG commented that no ESG-related accounting framework exists and that American research suggests that proxy advisors may interpret sustainability in different ways when providing voting and consultancy services. Overall, the SMSG considered that major obstacles stand in the way of investors wishing to take investment decisions based on ESG factors.
74. The group furthermore agreed with certain respondents to ESMA's public survey that it is too soon to draw conclusions on the performance of the NFRD. The SMSG requested further analysis which takes account of the effects of national NFRD supervision and the Commission's taxonomy and recently amended non-binding guidelines.

Stakeholder workshop

75. Workshop participants were invited to discuss the outcome of the public consultation and the input provided by an external speaker in an opening presentation²² in which it was observed that ESG investment is on the rise and that issuers with stronger ESG performance perform better financially. The ESG investment chain is complex, as disclosure often goes through ESG rating agencies, ESG index providers and / or ESG funds before reaching the investor and these actors apply different methodologies. The presenter recommended policy makers to (i) require issuers to use internationally agreed due diligence standards in their reporting; (ii) promote common reporting frameworks, aligned with international standards and (iii) improve disclosure and data quality across the investment value chain.
76. Most participants agreed that ESG disclosure is helpful to allow investors to assess the long-term prospects of an issuer. It was suggested that requiring targets for each disclosed ESG indicator would enable investors to use the information in a more forward-looking way. Several participants cautioned against confusing the increase in investors buying ESG data with investors actually basing their investment decision on such data, as it would be counterproductive and give the impression that the economy has become significantly more sustainable. On the balance between the three elements constituting the acronym ESG, it was pointed out that there has so far been more focus on E, less on S and that much work is left in relation to G.
77. Participants were somewhat divided on how to make EU legislation more effective. A number of participants observed that there is a need for more harmonisation and more detailed disclosure requirements, as the information which issuers currently provide is marred by problems with comparability and consistency. It was suggested that aligned reporting standards would enable issuers to focus their reporting, thus allowing investors to become independent from rating agencies and making it easier for auditors to provide assurance on the disclosure. However, not all participants supported the idea of having assurance on ESG information.
78. Another group of participants commented that disclosure frameworks and due diligence standards for ESG disclosure already exist and that assurance is already required in some Member States. These participants questioned the need for further requirements and cautioned that it is too early to evaluate whether the NFRD has brought about the necessary change. In addition, it was pointed out that if ESG disclosure requirements become very detailed, they might endanger the NFRD's materiality concept.

2.2.3. Analysis

79. ESMA's data collection seems to confirm that ESG disclosure can help counter undue short-termism in financial markets by complementing the information provided through

²² Please find the presentation [here](#).

traditional financial metrics with information on how issuers manage ESG factors that typically affect a company's future resilience and ability to create value for stakeholders. This enables investors who are willing to engage in long-term investments to better assess the level of preparedness of issuers to address the challenges posed by ESG factors and make their investment decisions accordingly. For example, ESG disclosures by issuers further help financial analysts – including sell-side analysts – factor information on an issuer's potential for long-term value-creation into their research. Similarly, when an issuer is also an investee company for other market participants, the issuer's ESG disclosures may be a necessary data point to feed the sustainability information that investment companies and advisors will have to provide in their turn under the new Regulation (EU) 2019/2088 (the Sustainable Finance Disclosure Regulation or SFDR). ESMA notes that these recently introduced requirements aim at addressing, amongst other things, the risk of greenwashing that also exists for the ESG disclosure of issuers.

80. However, the quality of ESG disclosure – in terms of comparability, relevance and reliability – is a key aspect to effectively relieve the overreliance on certain financial metrics which may on their own encourage a focus on short-term measures of performance. In this respect, ESMA observes that, while European issuers are still in the early days of their efforts to apply the NFRD requirements, investors increasingly demand ESG disclosures of adequate quality. It therefore appears there is a growing expectation gap between users and providers of ESG information which needs to be filled on a timely basis, in order to effectively support the shift towards a more sustainable financial system and ensure an adequate level of investor protection vis-à-vis the risks associated with limited or selective transparency by issuers on the non-financial factors affecting (and affected by) their business.
81. In this context, respondents to the public survey indicated a number of factors to explain the emergence and persistence of this expectation gap, most notably: (i) a lack of sufficiently forward-looking disclosure on ESG risks and opportunities; (ii) a lack of comparability between different companies' disclosure due to NFRD requirements not being sufficiently detailed and allowing use of various frameworks; (iii) a lack of a clear link between ESG matters and the company's current and future performance and (iv) a lack of consistency between companies' disclosed ESG policies and evidence of their actions. It is interesting to note that these shortcomings were also mentioned by some of the respondents who did not believe there is a positive relationship between ESG disclosure and long-term investment (most notably the factors relating to points (ii), (iii) and (iv)).
82. Intangibles have also emerged as a potentially relevant area in the context of countering the tendency towards short-termism. However, while acknowledging the relevance that intangibles play in the broader debate on long-term value creation, ESMA's data collection did not provide a clear picture of how disclosure of intangible assets which are not accounted for in the financial statements could concretely be improved to enable long-term investment decisions thus mitigating undue short-termism in financial markets. For this reason, and because ESMA considers that some of the value creation that flows

through intangibles is captured by ESG disclosure, ESMA does not separately address intangible assets in its below advice to the Commission.

83. The evidence arising from the review of the first reporting periods of application of the NFRD shows that these impediments are only partly caused by the relatively early stage of application of the NFRD. In fact, significant limitations relating to the applicable legislation limit the ability to provide ESG disclosure that is comparable, reliable and relevant. While the overall framework provided by the NFRD seems to be satisfactory in terms of the areas addressed and the objectives pursued, it appears that specific aspects pertaining to the implementation of the requirements pose significant obstacles to achieving effective ESG disclosure, most notably the following: (i) the lack of more specific requirements to prepare both narrative and quantitative disclosures in the areas addressed by the NFRD; (ii) the optionality regarding the location of the non-financial statement (i.e. included in the management report or presented separately) and the assurance on the information disclosed and (iii) the lack of coordination between the NFRD and Directive 2004/109/EC (the Transparency Directive).
84. According to ESMA's data collection, the issue mentioned in paragraph 83(i) regarding the specificity of the applicable requirements constitutes the most significant challenge to effective ESG disclosure and ESMA has therefore considered how this issue might be addressed. While encouraging signals of convergence have already emerged in the area of climate disclosures thanks to the TCFD recommendations, and while agreement seems to exist on the general principles that underpin high-quality ESG disclosure, recent efforts amongst major international standard setters and framework providers in the ESG domain still seem far from converging on a single high-quality disclosure framework capable of fulfilling all the requirements in the NFRD. As the development of a globally accepted single set of standards for ESG disclosure may require multiple convergence and consolidation stages over a number of years, there seems to be a need to address the abovementioned expectation gap in the shorter term. ESMA suggests that this should be done by considering interim solutions that can improve the quality of ESG disclosure in Europe while allowing a market-led convergence around a more stable and international standardisation to continue and be pursued as a medium-term objective.
85. ESMA also highlights that the lack of a defined set of specific requirements to fulfil the NFRD hampers the effective enforcement of ESG disclosure and the associated European efforts to achieve supervisory convergence in this area and makes any efforts to improve the assurance on the contents of non-financial statements difficult to achieve. ESMA furthermore notes that the lack of a homogeneous set of disclosure requirements prevents the development of electronic reporting requirements for non-financial statements.
86. Regarding the areas of optionality in the NFRD mentioned in paragraph 83(ii), ESMA notes that the possibility to include the non-financial statement either as part of the management report or to present it as a separate document has created divergence in the practice across different European Member States given the different choices made

in the national transposition process. Equally, Member States have implemented different requirements regarding the type of assurance required, again creating divergence across Europe. ESMA observes that the assurance on the contents of the non-financial statements is a key element to ensure the reliability of the information provided, also in light of concerns raised by several stakeholders regarding data quality issues for ESG disclosures.

87. With reference to the connection between the NFRD and the Transparency Directive mentioned in paragraph 83(iii), ESMA notes that coordinating the NFRD and the Transparency Directive is necessary for at least three reasons. Firstly, as the non-financial statement is not required under the Transparency Directive but under the Accounting Directive, it falls outside the scope of supervision of some national competent authorities.²³ Secondly, this lack of coordination also undermines the legal basis for ESMA's activity in promoting supervisory convergence on the non-financial statement as the Transparency Directive – which falls within ESMA's remit – does not explicitly refer to the non-financial statement. Thirdly, ESMA notes that when issuers present the non-financial statement outside the management report, it is not covered by the statement whereby responsibility is taken for the contents of the reported information (Article 7 of the Transparency Directive). In ESMA's view, a better coordination between the NFRD and the Transparency Directive is necessary to improve the reliability of the reported information as well as the level of oversight and contribution to consistent application that ESMA and European enforcers can guarantee on the non-financial statement.
88. ESMA highlights that the shortcomings identified in the existing legislation increase the gap in terms of comparability, relevance and reliability between ESG disclosure and traditional financial metrics, thus making it more difficult for the positive relationship between ESG disclosure and long-term investment to materialise.
89. Notwithstanding the different views as to whether improvements of ESG disclosure should result from a market-led initiative or be induced by mandatory standardisation, it is a common observation amongst several stakeholders that some minimum conditions are needed to improve the current situation, most notably (i) a set of principles that can ensure a minimum level of comparability, relevance and reliability of the disclosures required by the NFRD; (ii) a disclosure framework which remains compatible with the global perspective of financial markets in which preparers and users of ESG information operate and (iii) effective and consistent oversight over the application of the requirements. In terms of the types of measures that should be put in place to make the abovementioned improvements, ESMA notes that different views exist ranging from those who would recommend no changes in the NFRD given its recent application date to those who would suggest a revision of the NFRD or the introduction of an ad-hoc regulation to spell out more detailed requirements. In ESMA's view, the general

²³ Article 4 of the Transparency Directive cross-refers to Article 19 of the Accounting Directive for what concerns the content of the management report, but it does not cross-refer to the relevant articles setting out the provisions for the non-financial statement.

requirements provided for by the NFRD constitute a useful framework within which improvements can be made to better specify the mandatory contents of non-financial statements and ESMA has therefore taken the existing NFRD framework as the starting point for its advice to the Commission.

2.2.4. Advice

90. On the basis of the above analysis, ESMA sets out its advice on ESG disclosure below.

ESMA believes that European efforts should be focused on the three areas mentioned below with a view to strengthening ESG disclosure, while preserving proportionality of the measures adopted, to prevent short-term investment decisions due to investors' inability to assess issuers' long-term resilience and instead facilitate long-term investment.

As such, ESMA recommends the Commission to:

- (a) Consider amending the NFRD to allow for the development, by means of delegated acts, of binding measures providing for (i) key general principles underpinning high-quality non-financial information, including – but not limited to – guidance on the assessment of materiality and on the provision of forward-looking information on ESG risks and opportunities articulated over a reasonably extended time horizon; (ii) a limited set of specific disclosure requirements, including indicators and relevant targets to address the different requirements for each of the non-financial matters envisaged by the NFRD. This approach should enable a better coordination between the availability of data from investee companies and the disclosure obligation imposed on investment companies under the SFDR.

ESMA recommends that, in line with the process followed for the development of the Commission's non-binding guidelines on non-financial reporting and the annex on climate-related disclosures, the abovementioned requirements are based on the needs of different users and take into account the relevant existing international framework(s) which can be adopted to prepare the required disclosures. ESMA furthermore suggests that the requirements should be informed by a study on ESG data providers to ensure that concerns regarding data quality are addressed in a robust way.

ESMA recommends putting in place this limited standardisation as an intermediate step until a more complete standardisation can be achieved through the establishment of a unified set of international ESG disclosure standards that is consistent with the global nature of financial markets and sustainability challenges. To ensure the movement towards such a single framework in the international sphere, ESMA recommends that, in parallel with the efforts described above, the Commission assesses the feasibility of

promoting the adoption of a single set of international standards for ESG disclosures in the medium term. Such an assessment should be undertaken based on interaction with all the relevant framework providers to explore the possibility of achieving the necessary convergence and consolidation.

ESMA stands ready to assist the Commission in delivering on the above recommendations, including the development of more detailed measures in a delegated act and a study on ESG data providers.

- (b) Consider amending the NFRD to remove the optionality with regards to the location of the non-financial statement by requiring including it as part of the annual financial report and with regards to the assurance to be provided on the non-financial statement. ESMA recommends that external auditors are mandated to provide assurance not only on the *existence* of the non-financial statement but also on the *contents* of the statement and its *consistency* with the information provided elsewhere in the management report as well as in the financial statements and that it be assessed whether the existing standards cater for the specific assurance needs of non-financial information.
- (c) Consider amending the NFRD to establish the necessary coordination with the Transparency Directive. In addition to requiring that the non-financial statement is included as part of the annual financial report as provided for by Article 4 of the Transparency Directive as already mentioned under (b), ESMA proposes (i) introducing in the same Article 4 the appropriate cross-references to Articles 19a and 29a of the Accounting Directive for what concerns the contents of the (consolidated) non-financial statements; (ii) expanding the statement on the responsibility for the financial statements and the management report in Article 4(2)(c) to explicitly cover the preparation of the non-financial statement. The improved coordination with the Transparency Directive would, together with recommendation (a), also facilitate enabling electronic reporting for non-financial statements.

2.3. Fair value

2.3.1. Existing regulatory framework

91. For financial years starting on or after 1 January 2005, Regulation (EC) No 1606/2002 (the IAS Regulation) requires companies whose securities are admitted to trading on a European regulated market to prepare consolidated accounts in conformity with the International Financial Reporting Standards (IFRS). The objective of the IAS Regulation is the harmonisation of the financial information presented by issuers. This is in order to ensure a high degree of transparency and comparability of financial statements and thus an efficient functioning of the European capital market and of the internal market.

92. IFRS 13 *Fair Value Measurement*, effective since 2013, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or the liability under current market conditions, including assumptions about risk. IFRS 13 specifies how fair value is to be determined. It does not specify when an item is to be measured at fair value or when information about fair value is to be disclosed, as this is specified by the other standards addressing specific transactions, such as IFRS 9 for financial instruments accounting.
93. IFRS 9 *Financial Instruments*, effective since 2018,²⁴ introduced, among other things, a classification approach dependent on two tests – a contractual cash flow test and a business model assessment. If an asset does not meet the requirements of either tests, it is measured at fair value with all changes in fair value recorded in profit or loss (FVPL). For equity instruments, other than those held for trading and contingent consideration recognised in a business combination, IFRS 9 introduced an irrevocable option at inception to account for such instruments at fair value with all changes in fair value recorded through other comprehensive income (FVOCI). If the entity applies the FVOCI election, it does not assess these instruments for impairment and upon their disposal, it cannot reclassify in the statement of profit or loss any gains or losses previously recognised in other comprehensive income (OCI) (a practice often referred to as recycling).

2.3.2. Evidence

Literature review

94. The public debate and the academic research have addressed several aspects relating to fair value measurement, such as its value relevance and informative content (Barth et al. 1996; Barth et al. 2001), its role in the recent financial crisis (Laux and Leuz 2010) and its potential contribution to short-termism (Nölke and Perry 2006).
95. In its Final Report, the HLEG (2018) highlighted that an example of existing regulations which may encourage short-term behaviour is represented by the mark-to-market accounting rules for assets held in long-term portfolios. As a result, the HLEG recommended the Commission to investigate alternative accounting approaches to fair value / mark-to-market valuation for long-term investment portfolios of equity and equity-type instruments. The HLEG noted that fair value measurement would result in more income statement volatility resulting from market movements and in procyclicality.
96. In terms of the informative content of fair value, from an investors' perspective the CFA Institute (2013) observed that information provided by fair value is necessary to judge current financial health and helps assessing future performance and stewardship. André

²⁴ Please note that entities undertaking insurance activities are permitted to apply IFRS 9 on or after 1 January 2021.

et al. (2009) argued that fair value for financial instruments enhances comparability, as it removes the possibility of opportunistic management behaviour and ensures the neutrality of the measure of performance, i.e. based on disposing of an instrument rather than keeping it.

97. However, some limitations of fair value were highlighted by Veron (2008) who identified two main criticisms of fair value. Firstly, under certain market conditions, market prices may become irrelevant owing to a lack of liquidity, with potential negative spill-over effects. Secondly, fair value may exacerbate procyclicality, as it typically boosts balance sheets at the top of the cycle and reduces them at the bottom.
98. Magnan et al. (2015) also noted that although fair value may induce volatility, it nevertheless provides relevant information. Other scholars have underlined that the relevance of fair value may vary depending on the so-called fair value 'levels' and firms' environment. For example, Siekkinen (2016) found that fair values, irrespective of the level in the fair value hierarchy (1, 2 or 3), are relevant in countries with a strong or medium investor protection environment. In a weak investor protection environment, on the other hand, only market prices (level 1) are relevant. Fiechter and Novotny-Farkas (2017) indicated that institutional differences across countries may affect investors' ability to process and incorporate fair value information in their valuation.
99. While recognising the limitations of fair value, Veron (2008) argued that there are no credible alternatives. Linsmeier (2010) recalled that the amortised cost model failed to provide timely information about the deteriorating financial condition of failed banks in the recent financial crisis and that fair value measures are most highly correlated with banks' exposures to interest rate and credit risk, thereby indicating that fair value better reflects the performance and condition of banks. The CFA Institute (2013) emphasised that the benefits of fair value information for the investment community outweigh several commonly cited concerns. According to the CFA Institute, policymakers should therefore focus on ensuring that reporting entities correctly implement fair value measurement and consistently present the income statement. They should also clarify the defined purpose of OCI.
100. The external literature review commissioned by the IASB (2017) as part of their research work for the post-implementation review of IFRS 13 highlighted the following: (i) the disclosure of the fair value hierarchy is beneficial to investors and financial analysts as it allows them to perform more precise valuation of a firm and forecast of future earnings; (ii) while fair value overall is value relevant, the relative ordering of value relevance of the different levels within the fair value hierarchy (i.e. level 1, 2 and 3) seems to vary according to several factors, including the nature of the underlying assets, the market conditions, the institutional environment and managerial intent; (iii) depending upon their incentives, including the governance to which they are subject, managers will take advantage of their measurement discretion either to inform financial statements users (and thus increase the quality of reporting) or to deceive them (e.g. to achieve some earnings targets).

101. With respect to the use of specific accounting treatments to reflect the need of long-term investors or the specificities of some long-term investments, the IASB seems not to support a dichotomy between long- and short-term investors. As indicated in the basis for conclusions of the IASB's Conceptual Framework, long-term investors would need information that is also necessary for short-term investors, although long-term investors may also need some additional information (2018a). In two presentations (IFRS Foundation 2018a; 2018b), it is indicated that the IASB's view of fair value in relation to long-term investment is that (i) for long-term investments, cost is not relevant – even if an entity can wait for the value of investments to change – for example, for an equity investment acquired five years ago, its fair value provides more relevant information than its cost, no matter for how much longer it may be held; (ii) cost can be relevant if a simple bond or simple loan is held solely (or in part) to collect the principal and interest; (iii) long-term investments may expose an entity to more risk, best reflected by fair value. Furthermore, as already mentioned, in its conclusions on the post-implementation review of IFRS 13, the IASB (2018) did not identify any specific concerns with respect to the impact of fair value measurement on short-termism and long-term investment.
102. Concerns about both procyclicality and volatility of requirements to account for financial assets as provided for by IFRS 9 were considered from the perspective of financial stability by the European Systemic Risk Board (ESRB) in their 2017 report. In reviewing the existing literature in this area, the ESRB highlighted the importance of transparency provided by fair value measurement to permit market discipline by making relevant information available to market participants, thus enabling the efficient allocation of capital. The ESRB, however, also presented the advantages and disadvantages in relation to fair value measurement and noted that, while for trading assets there is hardly any disagreement that fair value accounting is appropriate, divergence of views exists regarding the appropriateness of fair value for assets that are mainly held for the collection of cash flows and only occasionally traded to manage liquidity or interest rate risk and for illiquid assets (other than loans), for which fair value measurement involves substantial discretion of managers.
103. The arguments for and against the use of fair value in the context of IFRS 9 have led the public debate on this topic to question the treatment of equity instruments at FVOCI and the lack of recycling. However, as IFRS 9 only came into force in 2018 and the vast majority of insurance undertakings have opted to defer its application to a later stage, there is very limited empirical evidence regarding the way in which entities may have changed their investment preferences following the implementation of the new standard. In this respect, the European Financial Reporting Advisory Group (EFRAG) in its 2015 endorsement advice on IFRS 9 expressed the view that measuring equity instruments at FVPL might not reflect the business model of long-term investors, but FVOCI is not likely to be attractive for this type of investors either due to the lack of recycling. More recently, in the context of its work to provide advice to the Commission on possible ways to improve the requirements of IFRS 9 on accounting for equity instruments from a long-

term perspective, EFRAG (2018)²⁵ considered recycling and its possible reintroduction in IFRS 9 but concluded that it did not have sufficient evidence to recommend it.²⁶

104. The IASB explained in the basis for conclusions of IFRS 9 that the prohibition to reintroduce recycling for equity instruments aims at avoiding major issues that an impairment model for equity instruments had historically caused, especially in light of the experience of the recent global financial crisis. In particular *“the IASB noted that recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. That would not significantly improve or reduce the complexity of the financial reporting for financial assets.”*²⁷ The IASB further explained that *“[t]he impairment requirements in IAS 39 for investments in equity instruments were very subjective and indeed were among the most criticised accounting requirements during the global financial crisis. [...] While recycling is prohibited, the IASB observed that an entity is not prohibited from presenting information in the financial statements about realised gains or losses on investments in equity instruments; for example, as a separate line item in other comprehensive income.”*²⁸
105. In a 2013 report, ESMA highlighted evidence in line with the IASB’s rationale for prohibiting recycling, noting in particular a wide range of application of the ‘significant or prolonged’ criteria among financial institutions for equity instruments accounted for as available for sale in accordance with IAS 39.²⁹
106. Finally, as part of its work EFRAG contracted an external review of the academic literature on the interaction of IFRS 9 and long-term investment decisions (Barone and Gullkvist 2018). The review concluded that accounting requirements may have a major effect on long-term investors, such as banks, life insurers and pension funds. However, the limited academic evidence on the effects of IFRS 9 and the related recycling issues make it difficult to draw conclusions about the possible effects of its requirements on the investment strategies of long-term investors.

Public survey

107. Through the public survey, ESMA sought to collect information on the relationship between fair value measurement and long-term investment and the role that transparency may have on the length of the investment horizon applied by investors in

²⁵ In a letter dated 29 May 2017, the Commission requested EFRAG to provide a technical advice on the accounting treatment of equity instruments under IFRS 9 from a long-term investment perspective.

²⁶ Upon a new request from the European Commission, EFRAG is currently undertaking additional work to assess potential alternatives to fair value measurement for equity and equity-type instruments held with a long-term perspective.

²⁷ See paragraph BC 5.25 (b) of IFRS 9.

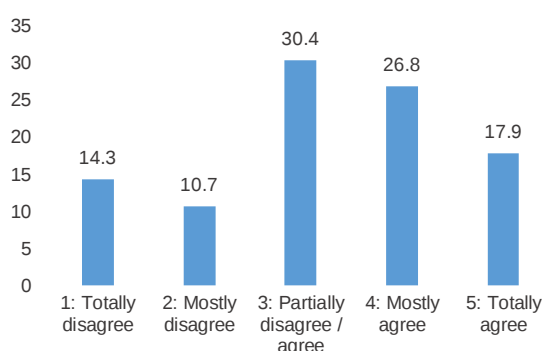
²⁸ See paragraphs BC4.153(a) of IFRS 9.

²⁹ [ESMA/2013/1664 Review of Accounting Practices Comparability of IFRS Financial Statements of Financial Institutions in Europe, 18 November 2013.](#)

large EU companies. Furthermore, ESMA collected evidence on any factors which may impact the relevance of fair value measurements.

Question 22

Table 11
Relevance of FV for internal assessments of long-term investments



Note: Replies to the question: 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, (Q22), %
Sources: Public Consultation ESMA

108. Fifty-seven responses commented on whether, 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- and long-term consequences of the investments held. 45% of respondents (25) either agreed or strongly agreed, 30% (17 respondents) neither agreed nor disagreed and 25% (14 respondents) disagreed or strongly disagreed.

109. Only 2 issuers or issuer associations responded that they mostly

agreed (17%) and none said they fully agreed. On the other hand, 20 respondents belonging to the category of investors or investor associations (50%) responded that they mostly or fully agreed.

110. Six issuers or issuer associations responded that they fully or mostly disagreed (50% of issuers responding to this question). On the other hand, 8 respondents belonging to the category of investors or investors associations (20%) responded that they mostly or fully disagreed.

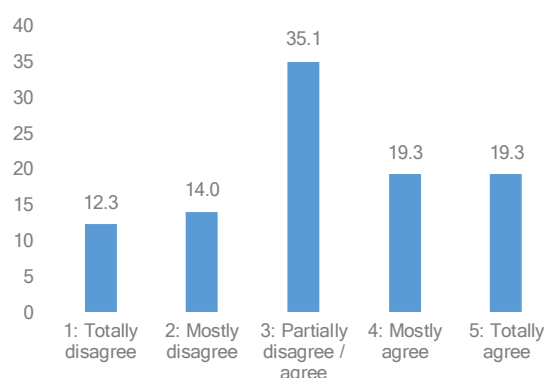
111. In the comments, those who agreed argued that:

- Fair value is the best available method for depicting performance in both the short and the long term:
 - In the short term because it reflects the price at which the investment could be sold if that were necessary;
 - In the long term because it reflects the expected cash flows that the investment is expected to generate;
- It is the only method which allows for meaningful comparison between different investments.

112. Those who neither agreed nor disagreed, or who disagreed, did so because they argued that the relevance of fair value depends on the instrument being valued. For these respondents, some categories of long-term investments may be best suited to a different approach. For instance, fair value is the most relevant approach for equity when instruments are actively traded (trading portfolio), whilst for illiquid assets historical cost and impairment rules may be more relevant. Alternatively, these respondents argued that fair value does not reflect (changes of) the value of an equity instrument held as a long-term investment – e.g. in the form of a strategic investment – to the reporting entity given that these investments usually result in economic benefits that are either not directly available to other market participants – e.g. due to competitive advantages – or not directly attributable to an investment on a stand-alone basis – e.g. due to synergies.
113. Other relevant arguments against fair value included that fair value incorporates recognition of point-in-time market-based value changes (subject to “noise” in the market) to which the reporting entity is not exposed in a long-term business model, or that OCI is largely misunderstood by investors.

Question 23

Table 12
Relevance of FV for external analysis of long-term investments



Note: Replies to the question: 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 (Q23), %
Sources: Public Consultation ESMA

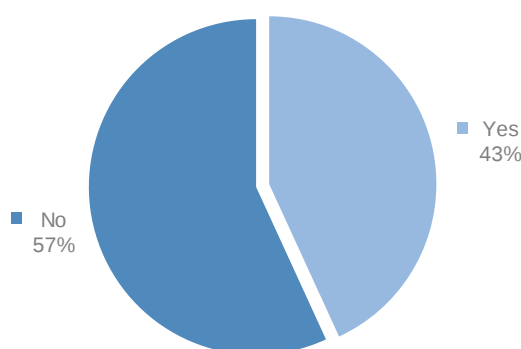
114. Fifty-eight respondents provided input on the question about whether, for the purpose of enabling an external analyst or investor to assess the performance of long-term investments held in equity instruments by a company, fair value provides relevant information in order to better understand the short- and long-term consequences of the investments. Thirty-eight % of respondents (22) either agreed or strongly agreed, 35% neither agreed nor disagreed (20 respondents) and 26% disagreed or strongly disagreed (15 respondents).

115. Only 2 issuers or issuer associations responded that they mostly agreed (18%) and none said they fully agreed. On the other hand, 18 respondents belonging to the category of investors or investor associations (45%) responded that they mostly or fully agreed.
116. Seven issuers or issuer associations responded that they fully or mostly disagreed (64%). On the other hand, 6 respondents belonging to the category of investors or investor associations (15%) responded that they mostly or fully disagreed.
117. Those who agreed argued that:

- Fair value is the most appropriate valuation measure in the current market environment and no alternative exists that gives the same level of transparency and comparability.
 - Analysts are perfectly able to understand and adjust fair value measures as long as comparability is maintained within and across businesses.
 - Fair value information provides relevant information to investors for similar reasons as it does to management, but the information gain to external investors in the company is more pronounced because they lack the detailed inside information that management has.
118. Those who neither agreed nor disagreed, or who disagreed, mainly expressed concerns because (i) the relevance of fair value depends on business model (fair value is not relevant for illiquid assets and long-term portfolios) and (ii) accounting classification does not integrate other criteria unknown by an external body (i.e. value deriving from synergies or strategic investments).
119. Overall, the arguments put forward resembled those used in answers to question 22.

Question 24

Table 13
IFRS 9 as decisive factor for undertaking new long-term equity investments



Note: Replies to the question: Is the current accounting treatment for equity instruments under IFRS 9 a decisive factor in discouraging a company from undertaking new long-term investments in equities?, (Q24), %
Sources: Public Consultation ESMA

120. ESMA received 52 answers to the question on whether the current accounting treatment for equity instruments under IFRS 9 is a decisive factor in discouraging a company from undertaking new long-term investments in equities. Of these respondents, 22 (around the 43%) responded yes and 29 (almost 57%) responded no.

121. As in the previous questions, the positions of issuers and investors were different. Sixty % of investors responded (29 respondents) that IFRS 9 is not a decisive factor, whilst 62% of issuers responded that IFRS 9 is a decisive factor (22 respondents).

122. Those who argued that the accounting treatment under IFRS 9 is not a decisive factor for undertaking new investments did so for the following reasons: (i) investors undertake long-term investments on the basis of operative and strategic considerations much more than on the basis of accounting considerations; (ii) the wider benefits of transparency,

consistency and comparability brought by IFRS 9 strengthens financial markets; (iii) investors and their advisors are able to understand and interpret IFRS 9 figures and fair value changes going through OCI; (iv) there is insufficient evidence on IFRS 9 to date.

123. Those who argued that the accounting treatment under IFRS 9 is a decisive factor did so because (i) measuring debt or equity instruments at fair value through profit & loss (P&L) (rather than OCI), irrespective of the economic substance and the business model, creates unnecessary volatility in reported earnings due to short-term temporary fair value changes which may disincentivise investors from seeking certain long-term investment opportunities available only through investment funds and (ii) the restriction of an investor's ability to recycle and recognise fair value gains into P&L on long-term equity investments – other than those held for trading – measured at fair value through OCI leads to a preference in equity investments with stable dividend distributions over long-term investment creating value mainly through capital gains.
124. Other relevant critical comments included that (i) depreciation should be reversible when prices get back to their former level; (ii) that IFRS 9 is too expensive administratively and is hard to follow and (iii) that IFRS 9 does not permit a similar treatment for equity and equity like instruments (listed equities funds, private equity funds).

Question 25

125. Fifty respondents commented on the question as to whether the current accounting treatment for equity instruments under IFRS 9 is a decisive factor in triggering divestment by a company of existing equity holdings elected for the long-term. Of these respondents, 65% responded no while 35% responded yes.
126. As in the previous question, a clear majority of investors answered that IFRS 9 is not a decisive factor (69%) for 17 respondents. On the other hand, issuers had split views, with 44% (32 respondents) responding that it is not a decisive factor.
127. Those who argued that the accounting treatment under IFRS 9 is not a decisive factor in triggering divestment, did so by arguing (i) that accounting does not have such strong influence in the way a quoted company designs its strategy and typically equities are held for external growth, corporate development, etc. – i.e. strategic objectives are not impacted significantly by accounting treatment; (ii) that there is no evidence yet available on the impact of IFRS 9; (iii) that IFRS 9 brings the benefits of consistent methodology and thus creates a level playing field; (iv) that IFRS 9 may rightfully trigger divestment in some cases because investors, just like companies themselves, continuously assess their portfolios, even those held for the long period, (v) that liquidity requirements are likely to override the effect of IFRS 9 for long-term strategies and (vi) that allowing recycling of gains on realisation would lead to manipulation of reported profits.
128. Those who argued that IFRS 9 is a decisive factor in triggering divestments, did so because (i) the volatility in P&L may lead to divestment because of fears of further losses and (ii) the administrative burden of accounting under IFRS 9 is not commensurate to its benefits.

129. Finally, two respondents argued that the option to record fair value charges through OCI (FVOCI) should be expanded to indirect holdings of equity instruments, which should therefore be treated as equity-type instruments.

Question 26

130. Sixty respondents provided input on the factors that may impact the relevance to users of financial statements of fair value measurements for long-term investments.
131. Of these respondents, most highlighted that volatility of reported earnings (33%) and management opportunistic behaviour for level 2 and 3 fair value measurements (32%) tend to impact the relevance of fair value for long-term investments. A high number of respondents also indicated measurement errors and complexity of calculations in level 2 or 3 fair value (27%) as potential factors. Insufficient involvement of independent third-party assessment in level 2 or 3 fair value and limited relationship with the expected developments of fair value in the long term were only considered relevant factors by 15% and 17% of respondents to this question respectively. A minority of respondents indicated that fair value is always relevant (5%).
132. It is interesting to note that the majority of the respondents who provided input regarding the factors which may impact the relevance of fair value measurement for long-term investments to users of financial statements did not necessarily think that these factors overall impaired the relevance of fair value for assessing performance of long-term investments as a whole. In fact, over 60% of those who indicated one or more factors which may impact the relevance of fair value also responded, under question 23, that they either agreed or neither agreed nor disagreed with the view that fair value is relevant 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.

Advice from the SMSG

133. The SMSG encouraged ESMA to investigate whether the higher volatility of balance sheets and income statements caused by the use of fair value accounting for financial instruments creates undue incentives leading to short-termism. It was also suggested that fair value may increase uncertainty in valuation, potentially leading to prudential concerns.
134. The SMSG furthermore highlighted that tensions may arise between fair value as a measurement basis and business models where long-term investments are not held for trading. It argued that the existing accounting treatment under IFRS 9 presents some shortcomings for equity and equity-like instruments, such as the lack of a dual measurement solution and the impossibility to reclassify (recycle) fair value changes booked in OCI to P&L upon disposal.
135. Finally, the SMSG cautioned against attempting to reflect ESG criteria in the existing fair value principles.

Stakeholder workshop

136. During the stakeholder workshop, participants were invited to share views on the existence of potential undue short-term pressures in financial markets arising from the accounting for financial assets, particularly equity instruments held for a long term, measured at fair value, and to discuss whether the factors which would trigger most decisively investment and divestment decisions in long-term holdings of equity and equity like instruments are related to fair value measurement.
137. In particular, one of the participants was invited to share views on the role of transparency on fair value measurement and its contribution to better investment decision-making through a presentation,³⁰ offering some elements for debate centred around the question as to whether short-termism is a behavioural phenomenon or necessarily a by-product of accounting. Even if accounting requirements may contribute to short-termism (just like it may be affected by tax, prudential factors and other types of drivers), it can be argued that the overarching aim of accounting is to give a faithful reflection of the state of affairs and provide decision-useful information. As such, an important question is whether transparency should remain the key driver of accounting requirements so to reduce information asymmetries between issuers and their stakeholders.
138. Participants who took the floor agreed that fair value is the best available measure of performance and no-one could see a direct link between short-termism and the use of fair value. All those who took the floor also agreed that the transparency brought by fair value measurements outweighs the volatility in the numbers, even if, as especially one participant highlighted, that volatility at times stems from an arguably excessive and short-lived change in quoted market prices following unexpected market developments.
139. With regards to the accounting treatment introduced by IFRS, participants noted that IFRS 9 has come into force too recently to know whether it will have any correlation with short-termist behaviour. Some argued that at any rate analysts will get used to the increased volatility. Two participants, however, raised the point that IFRS 9 should better reflect the business model and investment strategies of companies: long-term equity-like instruments should be allowed the same treatment as equity instruments and reintroduction of recycling upon disposal of long-term equity instruments (and hence a new impairment model) would be beneficial. However, as of today, the accounting treatment prescribed by IFRS 9 for equity instruments seems better than all available alternatives and the transparency introduced by fair value increases investors' confidence.

³⁰ The presentation is available [here](#).

2.3.3. Analysis

140. In its Final Report (2018), the HLEG indicated that *“there is considerable disagreement among interested parties on the appropriate accounting treatment for long-term investments, in particular on whether long-term assets on investors’ balance sheets should be valued based on the currently prevailing (daily) market prices – also known as ‘mark-to-market’ valuation or ‘fair value’ accounting [...] The debate is mainly around equity, equity-type and listed credit instruments on the balance sheets of long-term investors, such as non-financial corporations, insurance companies and banks.”*
141. ESMA acknowledges that this debate is rooted in the genuine concerns of different stakeholders regarding the measures to put in place in order to support the shift towards a more sustainable financial system. Therefore, for the purpose of providing this advice to the Commission, ESMA’s analysis has focused on determining whether there is any evidence that the transparency provided by fair value measurement results in distortions of the investment process that trigger undue short-term pressures in financial markets.
142. ESMA’s task, therefore, is not to identify whether fair value encourages long-term investment, as in ESMA’s view the primary objective of endorsed accounting standards remains to promote transparency and better decision-making in financial markets, which ESMA believes is the approach which is ultimately the most beneficial for the performance of capital markets, including their capacity to support long-term investments.
143. The outcome of the public survey, the evidence of the existing literature and the input provided by the SMSG and stakeholders participating in the workshop indicate that fair value is generally perceived as a useful measurement basis for both management and for investors. Neither the public survey nor the collection of evidence from literature has highlighted a clear channel of transmission between the use of fair value measurement and distortions of the investment process that trigger undue short-term pressures in financial markets.
144. However, some stakeholders argue that, specifically in the context of IFRS 9, fair value for equity and equity-like instruments may not always depict relevant information regarding long-term holdings due to the volatility which issuers are exposed to and the reliability of fair value estimates that are based heavily on management judgement.

Volatility

145. The feedback from the consultation shows that neither issuers nor investment analysts consider fair value changes in isolation but generally consider them as one of the elements of a more comprehensive assessment. In this respect, the volatility arising from fair value is one element that analysts and investors need to investigate and read through in order to fulfil their investment mandate. In other words, the transparency provided by fair value measurement gives users of corporate reporting insights into the risks and performance characterising the investments undertaken by issuers – including the ups and downs that they experience, but it does not constitute the only piece of

information that investors would look at. This is consistent with the feedback received on the ESG disclosures, whereas investors call for a broader data set encompassing both financial and non-financial information. From this perspective, the transparency provided by fair values as well as other financial information constitute one piece of a more complex jigsaw encompassing high-quality ESG disclosures and more relevant information on the strategy underlying corporate actions over a short-medium and especially long-term horizon.

146. ESMA also highlights that reducing the transparency on investments in equities held by issuers by adopting other measurement approaches that aim at smoothing volatility may rather confuse investors and users. This could end up triggering reactions which are not necessarily rational when compared to the information set that is available, for example, to corporate managers.
147. Regarding the treatment in accordance with IFRS 9, ESMA notes that equities that are held for the long term according to IFRS 9 can be accounted for at FVOCI in order to avoid volatility flowing through the P&L. Some stakeholders have raised concerns that this approach lacks a recycling solution and that it is not applicable to units in investment funds. According to these stakeholders, the shortcomings described above would undermine long-term investments in equities, including those held via funds, and further push issuers to make more intensive use of the FVPL category or to decrease their long-term investments. Both aspects would then result in short-termism.
148. ESMA observes that recycling would objectively create incentives for opportunistic short-term asset disposal policies which would be contrary to the objective of long-term investment. In addition, it is widely acknowledged that any reintroduction of recycling in IFRS 9 would need to be accompanied by a robust impairment solution that does not seem to exist at this stage. Therefore, the development of a solution that decreases the degree of transparency on fair value measures, providing an incentive for benefitting from the upside of certain investments and risking delaying the recognition of the potential losses inherent in those instruments, in ESMA's view would not serve investor protection and financial stability well, in the key role they play not only to counter the tendency towards short-termism, but also in the context of the broader European project of a Capital Markets Union.
149. For what concerns equity-type instruments, such as units in investment funds, ESMA also believes that measuring units held in investment funds at fair value through P&L is appropriate given their risk profile and complexity compared to direct equity holdings. Alternatively, a granular look-through approach would be necessary to account for equities indirectly held via the investment funds on the basis of the respective requirements in IFRS 9. However, ESMA questions whether this approach could result in significant complexity and whether it is consistent with the nature of the instrument invested in by issuers (i.e. a share in a composite portfolio vs. a selection of equity instruments).

Fair value and management judgement

150. Accounting is conventional in nature, based on amounts that *true-up* over time and amounts that are pure estimates whose reliability depends on the soundness of the approach used to determine the value and the reasonableness of the assumptions used. In this respect, fair value measurement is no exception in that it requires reliance on a certain model to determine the value of an instrument.
151. If, on the one hand, all stakeholders agree that market prices (level 1) are always relevant, even in a weak investor protection environment, on the other hand, the IASB's post-implementation review of IFRS 13 did not identify any major shortcomings in the guidance provided by this standard to make reliable level 2 and 3 fair value estimates either. Nevertheless, as the literature review indicated, the reliability of fair value when it is measured based on inputs that reflect management assumptions and cash flow estimates (i.e. level 3) largely depends on the institutional context. This is ultimately a function of different factors, including the internal corporate controls around the judgement exercised by management, the assurance work of auditors and the supervisory role of enforcers.
152. In ESMA's view, all stakeholders involved should be aware of the respective roles in ensuring that level 2 and 3 fair value measurements are reliable. ESMA especially highlights the need for issuers to place particular emphasis on the internal controls aiming at detecting potential cases of mis-application of best valuation practices aligned with the requirements in IFRS 13.
153. ESMA also notes that alternative measurement bases to fair value would in any case require some level of entity-specific estimates aiming at either assessing the potential impairment losses inherent in the instruments being accounted for or at determining a different valuation of the instrument at hand.

2.3.4. Advice

154. Based on the above considerations, ESMA presents its advice in relation to fair value below.

Three aspects have emerged clearly from ESMA's research in the area of fair value measurement, namely:

- (a) fair value is deemed to be a relevant measurement for both managers and investors, especially when compared to other potential alternative measurement bases, thus providing the necessary transparency that may support long-term investment and counter short-termism;
- (b) the volatility arising from fair value is not considered in isolation by users of corporate reporting and the selection of investment horizons does not fundamentally depend on fair value measurement for equity and equity-like

instruments; rather, fair value contributes to providing insights into the risks and performance characterising the investments undertaken by issuers;

- (c) neither the public survey, nor the collection of evidence from the literature has highlighted that fair value measurement results in distortions of the investment process that trigger undue short-term pressures in financial markets. In particular, there is no evidence – or at least, no evidence yet – on the consequences of the implementation of IFRS 9 on long-term investment practices. This lack of evidence may also be due to the recent application of IFRS 9 by most issuers in Europe and to the fact that the vast majority of insurance undertakings – which are typically considered to be long-term investors – have opted for a deferred application of IFRS 9.

On the basis of the collection of evidence and the analysis conducted, ESMA has not identified any need for amending existing requirements in the area of fair value measurement, particularly with respect to the treatment of equity and equity-like instruments in IFRS 9, to address concerns with undue short-termism.

2.4. Institutional investor engagement

2.4.1. Existing regulatory framework

155. In the area of institutional investor engagement, the regulatory framework was modified by the June 2019 entry into application of SRD II, which provides for a number of new tools to facilitate long-term shareholder engagement and to make it more effective. One of the assumptions underpinning the revision of Directive 2007/36/EC (the Shareholder Rights Directive or SRD) is that the monitoring role of shareholders is insufficient and that engagement should be reinforced to reduce excessive focus on short-term returns by management. This fundamental objective is highlighted in the actual title of the revised directive which indicates that the encouragement of long-term shareholder engagement is its key goal.
156. SRD II covers a number of topics that are directly or indirectly related to shareholder engagement with issuers. For example, Article 3(c) provides that intermediaries should facilitate the exercise of shareholders' rights, namely the right to participate and vote in general meetings. Article 3(g) mandates asset owners and asset managers³¹ to develop and publicly disclose an engagement policy that explains how they monitor investee companies and exercise voting rights on matters including strategy, financial and non-financial performance and risk, social and environmental impact and corporate governance. Furthermore, Article 3(j) sets out disclosure requirements for proxy

³¹ For the purpose of this section, asset owners and asset managers operating on their behalf are collectively defined as institutional investors.

advisors, also with reference to their adherence to a code of conduct. Finally, Article 9(a)(b) provides that companies should draw up a clear and understandable remuneration report and grants shareholders the right to vote on the remuneration policy.

2.4.2. Evidence

Literature review

157. In the aftermath of the 2008 financial crisis, institutional investor engagement has increasingly become an area of focus for academics and policy makers. Through engagement, investors may be able to influence the strategy of firms and the way in which they approach ESG issues. Because institutional investors, such as pension funds, tend to have a long-term liability structure and investment horizon, there is a general expectation that engagement could steer firms towards long-term value creation and social welfare maximisation rather than pursuit of simple market value.³² This literature review presents the main forms of engagement alongside the relevant evidence.
158. Traditionally, researchers have considered monitoring as the key tool to reduce the information asymmetries between shareholders and managers (Berle and Means 1933). The corporate finance literature has investigated this matter, concluding, however, that investors lack proper incentives to monitor (i.e. they suffer of 'rational apathy'), because rational shareholders exert the effort to make an informed decision only if the expected benefits of doing so outweigh the costs (Rock 2014). Therefore, free-riding issues operate as key obstacles to effective monitoring. In this context, Karpoff et al. (1996) found that shareholder proposals have negligible effects on stock performance and firm operations. Wohlstetter (1993) argued that shareholder proposals are even value-reducing because shareholders do not have the skills and information needed to guide management towards improved decision making,³³ and their engagement effort may vary depending on their business model (Celik and Isaksson 2015), including their active vs. passive investment strategy³⁴.
159. More recently, the literature has acknowledged that a variety of engagement possibilities are available to minimise the principal-agent problem (Ertimur et al. 2010) and investigated their ability to steer the strategy of the firm towards long-term value.³⁵ For example, Cuñat et al. (2012) showed that vote outcomes on specific issues, such as the

³² This is connected to the long-lasting debate on companies' goals, especially when such companies are listed. For a review and thorough assessment of this topic in connection to shareholder engagement please see Hart and Zingales 2017 and Jensen 2002.

³³ Similarly, early studies based on the analysis of large pension funds found a small impact of behind the scene engagement on target firms' governance structures, and a negligible impact on the firm's value or earnings.

³⁴ While the effectiveness of passive funds' engagement is heavily debated, the literature finds that both active and passive investors tend to engage with the investee companies, although the intensity, effectiveness and tools used for their engagement activity might vary. on this topic see Fish et al, (2015), Gompers et al, (2003), Bebchuk et al, (2009), FCA (2019),

³⁵ In this area, the Kay Review (Kay 2012) highlights that the less the shareholders are monitoring the company, the more the firm tends to undertake actions such as frequent internal reorganisation, inorganic corporate strategies on mergers and acquisitions and financial re-engineering which might reduce firm's and shareholders' value

adoption of governance proposals, have a positive impact on firm valuations, with an increase in shareholder value by 2.8% on average. Iliev and Lowry (2015) found that funds with active voting policies tend to earn superior risk adjusted returns. In addition to this, Greenwood et al. (2009) found that target firms gain abnormal returns due to the positive signalling effect of the implementation of engagement measures by shareholders, while Becht et al. (2008) reported that the governance engagements of a prominent fund led to an excess return of 4.9% net of fees against the FTSE All-Share index which cannot be attributed to stock-picking. However, some recent literature identified the lack of proper incentives as a key impediment to engagement and observed that several investors do not engage as they believe that corporate governance does not affect performance (Mc Cahery et al. 2015).

160. Engagement strategies can be classified according to three broad categories, namely (i) engaging in private conversations with management and the board; (ii) exercising voting rights at companies' shareholder meetings and (iii) proposing resolutions at companies' shareholder meetings (so-called shareholder proposals).³⁶ Yet, there is some fluidity around the term. Some consider engagement to be limited to behind-the-scene interactions, while others have a broader interpretation and consider that for example exit, takeover and publicly voicing displeasure constitute engagement strategies. For the purpose of this report, ESMA focuses on the three categories above, which is consistent with the scope of SRD II.³⁷
161. As regards (i), individual or collective dialogue between shareholders and management is an increasingly important form of engagement. Attempts by institutional investors to engage with the board have grown over time and private dialogue with directors is now an important instrument of institutional investor activism, as shown for example by Strampelli (2018). Corporate governance practice has played a major role in developing a framework for director-shareholder dialogue that seeks to prevent the violation of insider trading and public disclosure rules and to make dialogue more effective. Since private engagement is a practice that happens behind the scenes, it is inherently more challenging to investigate. However, empirical analysis shows that private discussions with directors have become one of the most popular measures of shareholder engagement by institutional investors. For example, Mc Cahery et al. (2015) found that 63% of the institutional investors surveyed have engaged in direct discussions with management. Additionally, Institutional Shareholder Services (2014) observed a reduced number of investors not engaging directly with either management or board member.

³⁶ It is acknowledged that, while these are the most common engagement forms, the spectrum of activities is potentially wider. For example, even though there is limited academic evidence, there are a plenty of anecdotal examples on how litigation (or the threat of such) might enable investors to steer the target company's strategy

³⁷ It is acknowledged that engagement is sometimes seen as just one element of a more comprehensive stewardship strategy, involving influence at different levels of intensity (The Investment Association 2018). For the purpose of this report and questionnaire, engagement was defined broadly as any monitoring and interaction by institutional investors to influence the investee companies, including the exercise of voting rights and other activities to influence the investee company.

162. As regards (ii), the exercise of voting rights is the most common form of engagement. Amundi (2018) reported that in 2018, US institutional investors exercised voting rights on 90% of their shares. While this percentage is clearly affected by the US legal framework that requires mutual funds to exercise their voting rights, an increasing trend in voting can also be observed in the EU where no such rule exists. In Europe, the empirical investigation of this issue has been complicated by data constraints on voting at Annual General Meetings (AGMs), as well as the fact that European countries are very diverse in terms of ownership structures, legal provisions governing shareholder rights and the monitoring incentives of and costs borne by shareholders (Renneboog et al. 2015). Nonetheless, evidence collected at national level shows that both the attendance and exercise of voting rights in the shareholders' meeting have picked up in certain cases (Belcredi et al. 2018; CONSOB 2018). However, this tendency is not consistent across countries, mainly due to entrenched and markedly differing sets of rules and approaches to holding general meetings which frequently provide barriers to foreign shareholder participation in meetings (Hewitt 2011).
163. As regards (iii), the use of shareholder proposals is relatively rare, at least in Europe. As argued by Mc Cahery et al. (2015), only 16% of the surveyed investors, mainly EU based, use shareholder proposals as a tool. Given the negative signalling mechanism that these proposals may have, investors typically try to engage with firms behind the scenes and prefer not to take public measures, which may also explain why a high number of shareholder proposals are withdrawn before the shareholder meeting.³⁸ In addition, it is harder to file a shareholder resolution in most European markets than in the US and this may explain why shareholders' proposals are scarcer in Europe than in the US (Horster and Papadopoulos 2018). When comparing shareholder proposal evidence from the UK and the US, Buchanan et al. (2012) showed that UK proposal rules are more onerous on the proposal sponsors, but UK proposals seem to be a more powerful governance device than in the US since they are binding and UK shareholders have the statutory right to call special meetings and elect directors.
164. The typical areas for shareholder engagement are governance and strategy. As shown by Mc Cahery et al. (2015), inadequate corporate governance and excessive compensation are considered by 88% of the institutional investors surveyed as somewhat or very important triggers. Another important trigger is disagreement with a firm's strategy, e.g. a proposed merger or acquisition (82%). These results indicate that investors not only engage over short-term issues but also, and even more so, over long-term strategic issues. The empirical literature also shows that institutional investors tend to support shareholder proposals which are thought to be wealth increasing and their support increases the probability that a proposal will pass and be implemented (Morgan et al. 2011). Recent evidence also suggests that passive institutional investors support

³⁸ In fact, proposals are met with strong negative stock price effects when they are voted upon at general meetings, reported by Renneboog et al. (2009). This suggests that rather than attribute them control benefits, the market often interprets proposals and their failure to pass the vote as a negative signal of governance concerns.

board independence, oppose takeover defences and oppose unequal voting rights (Appel et al. 2016).

165. Overall, considering the whole spectrum of engagement measures, there is some evidence on the beneficial role of engagement in terms of increasing shareholder value. For example, Cuñat, et al. (2012) showed that approval of corporate governance proposals via engagement strategies has a positive impact on shareholder value. In addition to this, Iliev and Lowry (2015) found that funds with active voting policies tend to earn higher risk-adjusted returns. As a result, it is argued that the more shareholders engage on corporate governance matters, the better the firm will perform. Interestingly, Gompers et al. (2003) illustrated that, over a 10-year horizon, firms that are the target of a strong investor engagement resulting in effective corporate governance can outperform firms with weak governance by 8.5% per year.
166. However, increased interest for environmental and social issues on the part of both investors and companies and the fact that many key governance practices have become widely adopted by most large cap companies are driving a shift of shareholder proposals from governance to environmental and social issues.³⁹ Indeed, ISS data (2014) showed that the filings of proposals dealing with environmental and social issues have now surpassed governance proposals in the US. According to the Governance & Accountability Institute (2018), in the US 86% of S&P 500 companies currently publish annual corporate responsibility reports where they communicate their approach to ESG and related matters to stakeholders.
167. Recent empirical literature increasingly investigates the ESG dimension. For example, Barko et al. (2017) found that firms with lower ESG indicators are more likely to be engaged and experience an improvement in their indicators during the engagement period. By analysing a case study, Dimson et al. (2015) found that a successful ESG engagement by a large institutional investor was followed by a yearly abnormal return of 4.4% and led to improved accounting performance and superior governance of the targeted companies.
168. Finally, it should be acknowledged that institutional investors often use proxy advisors to inform their engagement strategy (Mc Cahery 2015). As argued by Ertimur et al. (2013), proxy advisors respond to a market demand by processing a considerable amount of information and thereby reducing the information cost associated with voting. While there is often a general perception that proxy advisors may exert an influence on investors' votes, empirical findings on the actual reliance of institutional investors on proxy advisory recommendations greatly vary (Iliev and Lowry, 2015).

³⁹ This point has also been highlighted by several policy papers. Among others, see Financial Reporting Council 2020, according to which environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking serious engagement proposals,

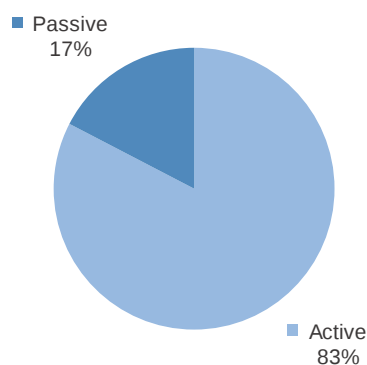
Public survey

169. ESMA sought to collect evidence on the role that engagement, especially by institutional investors, may have in influencing EU companies' long-term strategy. This section presents a summary of the input provided by respondents regarding the type of engagement activities put in place by institutional investors and the extent to which they incorporate long-term value considerations.⁴⁰ ESMA notes that all information collected is based on the regulatory framework in place in the relevant Member States at the time of the publication of the questionnaire.⁴¹

Questions 27 - 28

Table 14

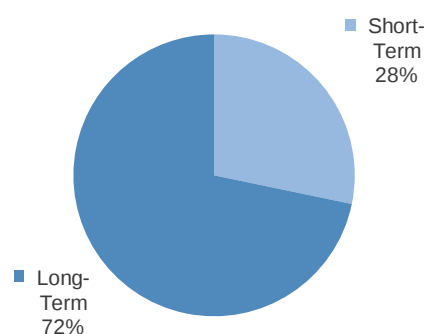
Active vs. Passive investment strategy



Note: Replies to the question: Is your investment strategy predominantly active or passive? (Q27)
Sources: Public Consultation ESMA

Table 15

Short-term vs. Long-term investment strategy



Note: Replies to question: Predominantly long-term or short-term?, (Q28i)
Sources: Public Consultation ESMA

170. Forty-six stakeholders responded to questions 27 and 28 on the nature and time horizon of their investment strategy. Respondents were invited to consider their responses in relation to the investment time horizon and holding period provided under questions 8 and 11, respectively. Overall, 38 respondents to the questionnaire indicated that they have a predominantly active investment strategy (83%) and 33 respondents tend to invest with a long-term horizon (72%).

171. Among those 33 respondents who indicated having a long-term active investment strategy, several explained that their approach is characterised by low portfolio turnover and focuses on sustainable value creation. On that basis, they conduct a thorough

⁴⁰ For the purposes of the ESMA questionnaire, engagement was defined broadly as any monitoring and interaction by institutional investors with investee companies, including the exercise of voting rights and other activities to influence the investee company.

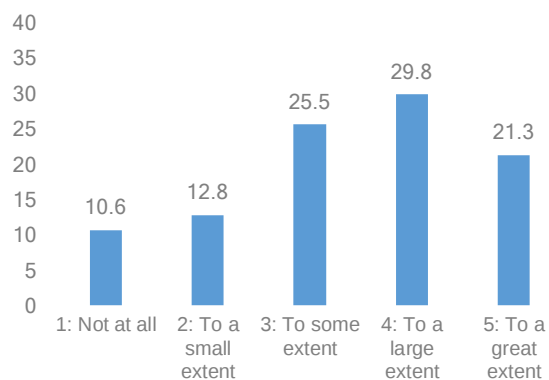
⁴¹ Please note that while the deadline for the entry into application of SRD II was on 10 June 2019, several Member States had not yet transposed the directive at the time of the public survey.

scrutiny of the companies they invest in, assessing, inter alia, the quality of corporate governance of investee companies. Respondents who identified themselves as long-term passive investors generally explained that their portfolio allocation follows a certain index / benchmark and is not decided by a portfolio manager. In most cases, this implies being a quasi-permanent owner of certain securities and therefore a long-term focus is an inherent part of their business strategy according to their clients' interest. Short-term investors often argued that their investment strategy is dictated by liquidity needs, the nature of their clients and / or the type of products they market. Finally, it is interesting to note that while considering themselves predominantly active and long-term, leading asset managers acknowledged that their equity holdings are nonetheless managed with a short-term horizon.

Questions 29 - 30

Table 16

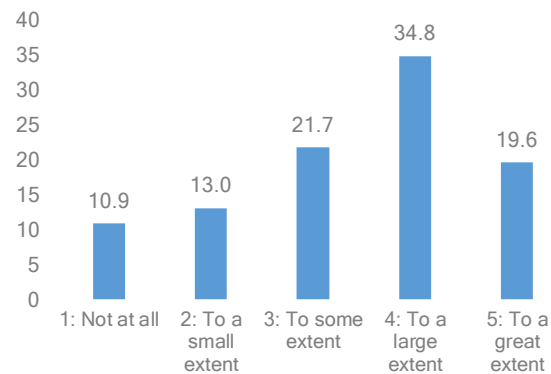
Long-term considerations in the investment strategy



Note: Replies to the question: to which extent does your firm integrate long-term value considerations for the purpose of setting its investment strategy (and subsequent portfolio allocation choices)? (Q29), %
Sources: Public Consultation ESMA

Table 17

Long-term considerations in the engagement policy

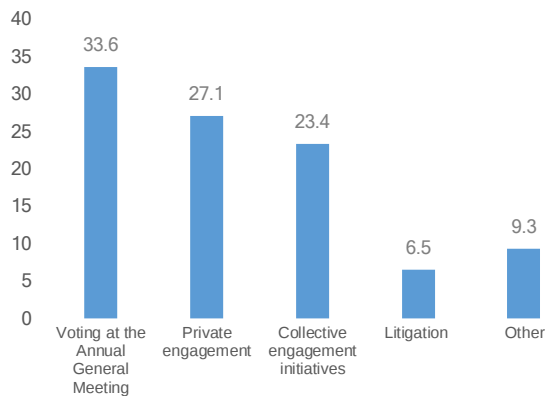


Note: Replies to the question: to which extent does your firm integrate long-term value considerations for the purpose of setting its engagement policy (and subsequent engagement activities)?, (Q30), %
Sources: Public Consultation ESMA

172. Forty-seven stakeholders provided input to question 29 which asked to which extent long-term value considerations are integrated in the investment strategy. In response to this question, half of the respondents indicated that they integrate such considerations either to a great or to a large extent, while an additional approximately 26% (12 respondents) stated that such integration is undertaken to some extent.
173. Only around 23% of respondents (11) mentioned that long-term considerations are either not integrated or integrated to a small extent. These respondents were invited to explain their responses. Some of them emphasised that their goal is exclusively to maximise returns and that no clear ESG-returns relation has yet been established. Others indicated that some regulatory elements within e.g. the UCITS Directive or IFRS push them in this direction.
174. Forty-six stakeholders provided input to question 30 in relation to the integration of long-term considerations for the purpose of setting an engagement policy. More than 50% (25 respondents) indicated that such considerations are taken into account to determine their engagement policy to a great or large extent, while an additional 22% do so to some extent. Respondents who mentioned that they integrate long-term consideration in their engagement policy to a small extent or not at all pointed to resource constraints. Interestingly, five respondents who identified themselves as passive investors, who consequently cannot integrate long-term considerations in their investment strategy as this is dictated by the benchmarks / indexes they follow, mentioned that their engagement policy focuses on long-term value creation.

Question 31

Table 18
Investor engagement tools



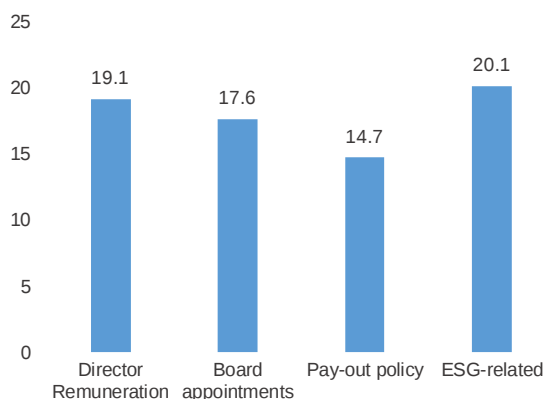
Note: Replies to question: how does your firm engage with the investee companies in order to mitigate any potential sources of undue short-termism?, (Q31), %
Sources: Public Consultation ESMA

175. Forty-five stakeholders responded to question 31 which invited input on how investors engage with investee companies in order to mitigate potential sources of undue short-termism. One third of the responses indicated voting at the AGM as a preferred method of engagement and broadly one out of four responses flagged the use of private engagement and / or collective engagement strategies. Emphasis was placed by several respondents on the importance of direct interaction with the investee company's board members. Only around 7% of responses selected litigation (7 respondents), which is seen as a last

resort tool to be used in extreme circumstances. Among those indicating other tools used for engagement, some respondents mentioned board participation, including by leveraging on specific appointment rules for minorities, the possibility to give a mandate to a proxy advisor, making some of their concerns public as well as the use of softer tools, such as written correspondence and workshops among market players.

Question 32

Table 19
Engagement topics



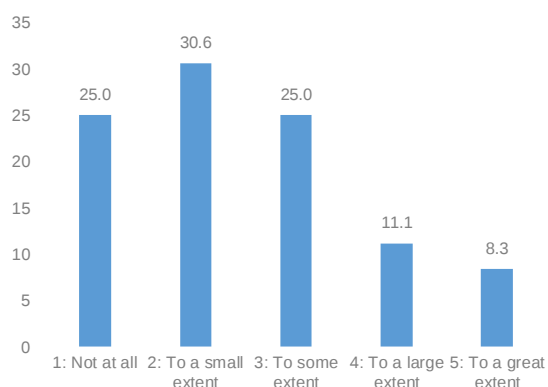
Note: Distribution of replies to the question: what are the main topics your firm engages on in order to mitigate any potential sources of undue short-termism? (Q32), %
Sources: Public consultation ESMA

176. In response to question 32, 36 respondents provided an indication of the main topics on which engagement takes place with a view to mitigating potential sources of undue short-termism. ESG / sustainability related factors (20% - 41 respondents) and remuneration of directors (19% - 39 respondents) were seen as the main topics for engagement. Board appointments (including board diversity, independency and tenure, 17% - 36 respondents) followed together with decisions on pay-out policy (14% - 30 respondents). Finally, related party

transactions were flagged by less than 10% of the responses (20 respondents). Other topics mentioned as a means of mitigating undue short-termism were long-term contracts for directors, company reporting and auditing, appointment of minority directors, shareholder rights, climate change, oversight of strategy and risk, fraud and corruption.

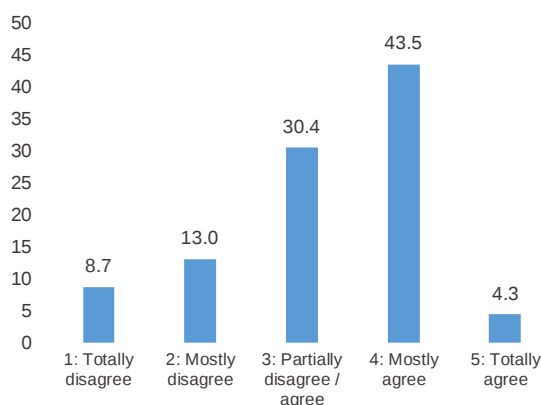
Questions 33 - 34

Table 20
Reliance on proxy advisors



Note: Replies to question: to which extent does your firm rely on proxy advisors for the purpose of deciding how to vote in order to mitigate any potential sources of undue short-termism?, (Q33), %
Sources: Public Consultation ESMA

Table 21
Long-term considerations for voting advice



Note: Replies to question: proxy advisors take into consideration long-term value when they provide voting advice?, (Q34), %
Sources: Public Consultation ESMA

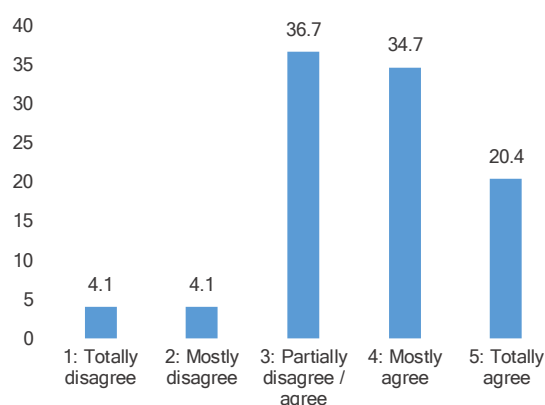
177. Thirty-six respondents provided input to question 33 on the extent of reliance on proxy advisors for the purpose of voting at AGMs in order to mitigate potential sources of

undue short-termism. Around 20% of respondents (7) mentioned that they rely on proxy advisors to a great or large extent, while the remaining respondents indicated that they either do not use proxy advisors for the purpose of deciding how to vote to mitigate potential short-term pressures or that they rely on their input only to a small or some extent. One of the reasons cited for not using proxy advisors is that investors prefer to rely on their own judgement (both from their ESG / stewardship and equity management teams). On the other hand, respondents who mentioned that they rely on proxy advisors tend to use advice from one or two of them and argued that this input is complemented with internal corporate governance / ESG or stewardship analysis. Internal teams dealing with such work generally appear small (i.e. <5 full-time equivalents), although a few notable exceptions exist.

178. Coming to question 34 which received responses from 49 stakeholders, almost 50% of respondents (22) indicated that they totally or mostly agree with the statement that proxy advisors take into consideration long-term value when they provide voting advice. This view was mainly substantiated by providing respondent-specific experience as well as by the fact that proxy advisors use the respondent's voting policy which is long-term oriented. On the other hand, 30% of respondents (14) neither agreed nor disagreed with the abovementioned statement. A few of these respondents considered that proxy advisors are not necessarily interested in such long-term considerations and / or that their assessment tends to be of a one-size-fits-all nature.

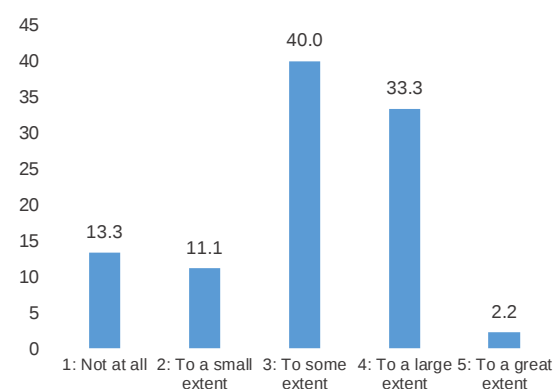
Questions 35 – 36

Table 22
Effectiveness of engagement activities



Note: Replies to question: engagement activities can be an efficient way of mitigating any potential sources of undue short-termism?, (Q35), %
Sources: Public Consultation ESMA

Table 23
Effectiveness of own engagement activities



Note: Replies to Q36 of the Public Consultation: to which extent do you consider your engagement activities successful in mitigating any potential sources of undue short-termism?, (Q36), %
Sources: Public Consultation ESMA

179. Forty-nine respondents provided input to question 35, and 45 responded to question 36 on the effectiveness of engagement activities in mitigating potential sources of undue short-termism. Interestingly, while around 55% of answers (27) agreed that engagement activities can in general be an efficient tool to reach this goal, only 35% of respondents

(16) to this question considered that their own engagement activities are either to a large or a great extent successful.

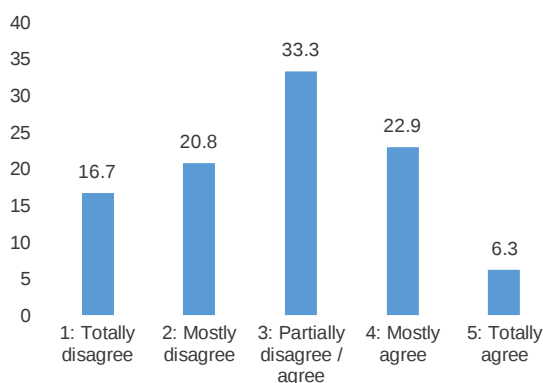
180. Overall, in response to question 36 respondents mentioned that it is not easy to evaluate the achievement of long-term goals. They considered, though, that engagement actions with investee companies seem to produce results, e.g. when it comes to corporate governance and remuneration decisions. However, it was also pointed out that several legal obstacles to engagement persist in relation to cross-border voting or investor cooperation. Finally, a few respondents highlighted that engagement activities can also be used to reach short-term goals, depending on the type of investor.

Question 37 - 38

181. Question 37 invited stakeholders to mention the main obstacles that institutional investors face when engaging with investee companies and how these could be addressed. Thirty-nine respondents provided input to this question and several respondents indicated that engagement is costly. They highlighted that issuers are often responsible for poor disclosure to investors and limited alignment with investors' strategy, although engagement at board level might make a difference. In the view of these respondents, collective engagement is an effective solution, but regulatory risks coming from cooperation were also highlighted, such as those under Directive 2004/25/EC (the Takeover Bids Directive) and Regulation (EU) No 596/2014 (the Market Abuse Regulation or MAR). Other respondents pointed out that a race to the bottom among active investors may be taking place as these investors might prefer to exit the investee company rather than voice their concerns. Conversely, passive investors were believed to have better incentives to focus on engagement, but they also suffer from stronger fee pressure. Some respondents pointed out that voting, especially at cross-border level, is still seen as an obstacle to engagement. Several corporate governance rules set at national level were also perceived as an obstacle to engagement. These include rules on acting in concert, despite relevant ESMA guidance in this area.⁴²

⁴² [ESMA31-65-682 Public statement Information on shareholder cooperation and acting in concert under the Takeover Bids Directive, 8 February 2019](#)

Table 24
SRD and long-term engagement



Note: Replies to question: 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?, (Q38), %
Sources: Public Consultation ESMA

182. Question 38 followed up to the input provided to previous questions by focusing on the impact of the recently revised regulatory framework in shifting the behaviour of firms and any regulatory improvements that could be considered. It received 48 responses. Interestingly, the relative majority (33% - 16 respondents) of respondents did not appear to have a clear opinion and less than 30% of respondents (14) believed that SRD II is going to increase the extent to which their firm takes long-term value considerations into account for the purpose of setting its investment strategy and engagement policy.

Furthermore, 37% of respondents (18) seemed to believe that the impact of the new rules on actual investment choices is likely to be small and that a tick-box approach to compliance might prevail. On the opposite side of the spectrum, 29% of respondents (14) supported the view that SRDII will be beneficial in promoting better stewardship standards, clarity of communication between asset managers and owners and long-term value creation for the whole market. Generally, respondents believed a principle-based approach to this area to perform best together with the recourse to self-regulatory solutions. However, a few respondents also indicated that a more hands-on regulatory approach would be needed to address short-termist behaviours.

Advice from the SMSG

183. The SMSG noted, inter alia, that, while the effect of SRD II remains to be seen, Member States are required under the new regime 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. In the view of the SMSG, this marks a strong focus on transparency and disclosure and is an important first step.

Stakeholder workshop

184. The roundtable discussion on engagement focused on two main areas.⁴³

185. Firstly, it was observed that institutional investors' effectiveness in steering company strategy, notably with reference to how they achieve their long-term goals, should not be overstated. As such, also some of the assumptions at the basis of the revision of the

⁴³ Please see the presentation [here](#).

SRD should be taken with caution. In particular, and in line with the literature review earlier in this section, it was argued that several authors show that institutional investor engagement is not necessarily effective due to a number of issues, such as: (i) the scarce incentives for institutional investors to engage (rational apathy and free riding issues); (ii) the legal risks arising from collective engagement, such as those in the area of takeover and market abuse regulation; (iii) fund managers' tendency to only slightly distance themselves from benchmarks (i.e. adopt a passive strategy).

186. In this context, it was also highlighted that resources devoted to engagement remain too scarce, both from investors' and companies' side, and passive reliance of investors on proxy advisor analysis remains too high. In addition, a few participants indicated that proxy advisors might not always be able to fully take on board ESG considerations in their advice. However, the implementation of SRD II was seen as a step in the right direction, although workshop participants considered that it is too early to have a fair assessment. In particular, AGM votes were deemed effective to reinforce institutional investors' incentives to engage.
187. Secondly, it was argued that although the link between financial performance and ESG is not always very clear, there is increasing evidence that end investors also pursue social values and as such may select companies that maximise their own values rather than only market / share value. It can be expected that with the number of social value investors gradually increasing, ESG performance might become a driver of competitiveness in the funds market. Still, it was also highlighted that the role of governance in the context of ESG should be reinforced, both on the companies' and investors' side, and become a key part of their dialogue. At the same time, it was observed that if corporate responsibility focuses strictly on social values, there is a risk that companies may become less competitive and accountable to the market.

2.4.3. Analysis

188. As discussed above, SRD II provides for a comprehensive set of provisions to encourage shareholder engagement in EU listed companies, including by means of an active exercise of ownership rights. As background information, ESMA recalls that SRD II came up in the aftermath of the financial crisis and partly implemented the Commission's Corporate Governance Action Plan (2012)⁴⁴ that set out a number of actions in the area of corporate governance aiming at encouraging long-term engagement and enhance transparency between companies and investors. As the second recital of SRD II indicates, *"the financial crisis has revealed that shareholders in many cases supported managers' excessive short-term risk taking. Moreover, there is clear evidence that the current level of 'monitoring' of investee companies and engagement by institutional investors and asset managers is often inadequate and*

⁴⁴ [Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European company law and corporate governance — a modern legal framework for more engaged shareholders and sustainable companies, COM\(2012\) 740 final, 12 December 2012](#)

focuses too much on short- term returns, which may lead to suboptimal corporate governance and performance.”

189. ESMA points out that the regulatory framework was not only recently modified, but the goal and rationale underpinning the modifications clearly recognise the importance of reducing potential undue short-term pressures from investors to corporates and their management. Therefore, in line with the Commission’s better regulation agenda, there might be merit in further observing the impact of SRD II before considering revisions. Nonetheless, having considered the relevance of the topic and the important role that institutional investors may play in supporting a long-term view, ESMA sought information on how engagement activities were put in place at the time of the publication of the survey, based on the existing regulatory framework in the relevant Member States.
190. In particular, ESMA collected evidence from market participants to understand (i) to what extent they take into account long-term value considerations for the purposes of their engagement activities; (ii) how long-term engagement takes place and its effectiveness; (iii) overall, whether and to what extent SRD II is perceived by market participants as an effective response to undue short-term pressures.
191. ESMA’s investigation has shown that long-term engagement is increasingly widespread among investors. However, the evidence collected is not conclusive on whether SRD II will be able to increase the extent to which long-term value considerations are taken into account for the purpose of making investment choices. Respondents’ views were more optimistic on the role that SRD II can play in the area of transparency between investors and issuers, although the risk of a box-ticking approach was not ruled out.
192. Interestingly, the results of public survey also indicated that long-term engagement increasingly addresses sustainability-related topics, for example when it comes to AGM voting. In ESMA’s understanding, sustainability goals have a great deal in common with long-term investments and therefore a proper management of ESG risks is well aligned with long-term investor goals. In this context, ESMA considers that some targeted improvements to the regulatory framework in that direction could be beneficial, taking into account that SRD II does not explicitly connect long-term engagement activities and disclosure of ESG factors.
193. ESMA believes that integrating ESG aspects more overtly in SRD II could make the relevant provisions more effective in bringing about actual improvements in the market. In particular, ESMA finds that SRD II’s general support for further transparency on institutional investors’ long-term investment strategy – as well as their engagement policy should be associated with a duty to make use of ESG metrics and indicators whenever applicable.⁴⁵ In case institutional investors do not make use of such

⁴⁵ Indices and benchmarks should be based on robust quantitative parameters. It is acknowledged that some investment indices consider companies’ attention to ESG factors but are highly discretionary as they are mainly based on questionnaires and generally focus on larger companies only.

parameters, they should be required to provide adequate justification of why ESG parameters were not deemed appropriate.

194. ESMA also acknowledges that institutional investors' commitment towards better disclosure on the long-term goals of their investment strategy, as measured by specific ESG standards, goes hand in hand with more granular disclosure on the side of the company. As argued in section 2.2. of this report, issuer disclosure on material ESG risks and opportunities and broader sustainability factors is becoming increasingly important to investors who seek to integrate these factors into their investment process.
195. While it is commonly agreed that sustainability factors and risks should become increasingly relevant in setting an issuer's strategy, different views exist on whether sustainability-related disclosures should be subject to a specific say by the shareholders. As such, ESMA suggests that the Commission should carefully consider whether, for those companies that fall under the obligation to publish a non-financial statement, a general advisory vote on that document could serve as an effective tool for investors to voice any concern they might have on the way investee issuers approach sustainability risks. In ESMA's view, at least for those companies, this would be a preferable option to the introduction of ad-hoc votes on a specific document, such as a sustainability policy. Indeed, ESMA finds that duplications of disclosures and votes might not be conducive to enhanced engagement but might rather increase risks of fragmentation of investors' efforts. In addition, ESMA believes that, in order for sustainability issues to be fully integrated in a company's strategy, they should be analysed together with other material non-financial risks and therefore be included in the non-financial statement as part of the annual report.
196. One further input coming from ESMA's consultation is that collective engagement is widely seen as the most cost-effective form of engagement, especially for institutional investors. It is often argued that appropriate engagement requires institutional investors to allocate considerable resources, especially when companies' disclosures are not sufficiently self-explanatory and dialogue with their management or board members is needed. While collective engagement is regarded as an effective solution, regulatory risks coming from cooperation were also highlighted (such as those under the Takeover Bids Directive and MAR).
197. As such, ESMA finds that action could be taken in areas of the regulatory framework that potentially facilitate (collective) engagement, for example by providing further clarity on the boundaries of acting in concert by institutional investors. In that regard, in 2013 ESMA published a so-called White List of activities that shareholders can cooperate on without the presumption of acting in concert under the Takeover Bids Directive⁴⁶. This was aimed to operate as a reference across different EU jurisdictions and thereby to

⁴⁶ [ESMA31-65-682 Public statement Information on shareholder cooperation and acting in concert under the Takeover Bids Directive, 8 February 2019](#). This document clarifies the concept of "acting in concert" at EU level in order to lessen uncertainty for institutional investors who wish to collectively engage on corporate governance topics.

facilitate that investors collectively engage without incurring the risk of triggering unintended legal consequences, such as in particular the obligation to launch a mandatory bid. However, this list has not been revised since then and ESMA considers that it might be worth assessing if it needs to be reviewed. One particular area of analysis could be to assess whether the White List should explicitly include coordination activities among institutional investors in the area of ESG risks in order to address potential obstacles to related engagement.

198. ESMA's public survey also gathered input on the role of proxy advisors in the context of long-term engagement. Most respondents indicated that they mainly rely on their own judgement, rather than on proxy advisors, for the purpose of deciding how to vote to mitigate potential short-term pressures. However, it was flagged by several respondents that proxy advisors might not always take into account long-term considerations when providing their voting recommendations. Furthermore, it was indicated that their advice may at times be affected by conflicts of interests and a tendency to be based on high-level principles and a one-size-fits-all approach that might not be suitable when it comes to sustainability.
199. ESMA assessed the proxy advisory industry and the potential case for regulatory action with several public documents issued between 2012 and 2013,⁴⁷ finding no sufficient grounds for imposing mandatory rules on proxy advisors. This topic was then addressed by SRD II that put in place a number of provisions that overall reinforce the role of the industry's self-regulatory code. Following ESMA's input⁴⁸ that this code had room for improvement, the industry group in charge of the code has recently reviewed its content and functioning.⁴⁹
200. SRD II provides for a review to take place by June 2023.⁵⁰ ESMA suggests that – in the context of the preparatory work that will lead to that review – the Commission also assesses whether the current approach envisaged by SRD II has been effective from the standpoint of ensuring that proxy advisors do not contribute to putting undue short-term pressure on (listed) companies. Furthermore, it will be important to keep in mind that – in order to be effective – any direct regulatory requirement for proxy advisors should be associated with related supervisory powers appropriately reflecting the level of market concentration.
201. Finally, it was brought to ESMA's attention that additional incentives – such as increased dividend or voting rights, e.g. via loyalty shares – should be introduced to promote

⁴⁷ [ESMA/2012/212 Discussion Paper An overview of the Proxy Advisors industry. Considerations on possible policy options, 22 March 2012](#); [ESMA/2013/84 Final Report Feedback statement on the consultation regarding the role of the proxy advisory industry, 19 February 2013](#). In this latter report, ESMA found no sufficient evidence of market failure to justify a regulatory intervention.

⁴⁸ [ESMA/2015/1887 Report Follow-up on the development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis, 18 December 2015](#)

⁴⁹ [BPPG \(2019\), Best Practice Principles for Providers of Shareholder Voting Research & Analysis, second edition](#)

⁵⁰ See Article 3(k)(2) of SRD II.

shareholders' long-term perspective. Here, ESMA finds that, while a few Member States recently introduced similar mechanisms in their legal framework⁵¹, it could be worth assessing the impact of such regulatory novelties before similar actions are taken at the EU level. ESMA stands ready to assist the Commission in this assessment as well as in other work needed to support the above goals.⁵²

2.4.4. Advice

202. On the basis of the above considerations, ESMA presents its advice to the Commission below.

In the area of institutional investor engagement, ESMA recommends that:

- (a) The Commission should consider whether a vote on the non-financial statement could serve as an effective tool for investors to voice any concern they might have on the way investee companies approach sustainability risks.
- (b) The Commission should mandate ESMA to review the Public Statement on Information on shareholder cooperation and acting in concert under the Takeover Bids Directive (the White List). One specific area of analysis could be to assess whether the White List should explicitly include coordination activities among institutional investors in the area of ESG risks.
- (c) As part of the review provided by Article 3(k)(2) of SRD II, the Commission and ESMA should assess whether the provisions under Article 3(j) of SRDII have been effective from the standpoint of ensuring that proxy advisors do not contribute to put undue short-term pressure on (listed) companies.
- (d) The Commission, in close cooperation with ESMA, 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 and consider whether EU-harmonised incentives would be necessary.
- (e) In addition to what is specified in the review clauses under Articles 3(f)(2) and 3(k)(1), the Commission and ESMA should ensure appropriate monitoring of the broader application of SRD II in order to assess whether it effectively encourages long-term engagement.

⁵¹ See for example Mosca C. (2019), Should shareholders be rewarded for loyalty? European experiments on the wedge between tenured voting and takeover law, Michigan Business & Entrepreneurial Law Review, forthcoming.

⁵² Due to the specific ESMA remit in the area of corporate governance and takeover, the Commission should consider issuing explicit mandates for ESMA when necessary to ensure that the actions required fall squarely into its scope. See Article 3(1) of the ESMA Regulation.

2.5. Remuneration of fund managers

2.5.1. Existing regulatory framework

203. Article 14a of the UCITS Directive and Article 13 of Directive (EU) 2011/61/EU (AIFMD) stipulate that UCITS management companies and alternative investment fund managers (AIFMs) must establish and apply remuneration policies and practices that are consistent with, and promote, sound and effective risk management and that neither encourage risk taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the funds that they manage nor impair compliance with the management company's duty to act in the best interest of the funds.
204. The remuneration policies and practices include fixed and variable components of salaries and discretionary pension benefits. They apply to those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profiles of the management companies or of the funds that they manage.
205. UCITS rules are further detailed in ESMA's guidelines on sound remuneration policies under the UCITS Directive.⁵³ AIFMs must ensure that their remuneration policies and practices follow principles laid out in a separate Annex II in AIFMD, also detailed further in the corresponding ESMA guidelines.⁵⁴
206. These common principles for both UCITS and AIFMD include, inter alia, requirements that:
- the remuneration is consistent with and promotes sound and effective risk management and does not encourage risk-taking inconsistent with the fund;
 - the remuneration policy is in line with the business strategy, objective, values and interests of the management company or AIFM, the fund and its investors, and includes measures to avoid conflict of interest;
 - where remuneration is performance-related, the total amount of remuneration is based on a combined assessment of the performance (i) of the individual and of the business unit or fund concerned and (ii) the risks and the overall results of the management company when assessing individual performance, taking into account financial and non-financial criteria;

⁵³ [ESMA/2016/575 Guidelines Guidelines on sound remuneration policies under the UCITS Directive, 14 October 2016](#)

⁵⁴ [ESMA/2013/232 Guidelines Guidelines on sound remuneration policies under the AIFMD, 3 July 2013](#)

- the assessment of performance is set in a multi-year framework appropriate to the holding period recommended to the investors of the fund managed by the management company or AIFM in order to ensure that the assessment process is based on the longer-term performance of the fund and its investment risks and that the actual payment of performance-based components of remuneration is spread over the same period;
- guaranteed variable remuneration is exceptional, occurs only in the context of hiring new staff and is limited to the first year of engagement;
- the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes a comprehensive adjustment mechanism to integrate all relevant types of current and future risks;
- a substantial portion, and in any event at least 50%, of any variable remuneration component consists of units of the funds concerned, equivalent ownership interests or share-linked instruments or equivalent non-cash instruments with equally effective incentives as any of the instruments referred to in this point – these instruments must also be subject to an appropriate retention period designed to align the interest of the management company or AIFM, the fund and the investors;
- a substantial portion, and in any event at least 40%, of the variable remuneration component, is deferred over a period of a minimum of 3 to 5 years for AIFMs and 3 years for UCITS management companies, appropriate to the holding period recommended to the investors of the fund concerned and is correctly aligned with the nature of the risks of the fund.

2.5.2. Evidence

Literature review

207. ESMA staff conducted a literature review which underlined the challenge in aligning the interests of the fund manager with the risk of the fund and the interests of investors.
208. In particular, short-termism seems to be mainly driven by the pursuit of short-term earnings and behavioural factors. On the first point, the performance of corporate executives and investment managers is frequently assessed on a short-term time horizon (Casamatta and Pouget 2015), considering that there is a link between short-term earnings with a company's share price – a key determinant of senior executives' compensation. Similarly, the performance of investment funds is often measured against recent investment returns, and portfolio managers are compensated on the basis of that short-term performance (Roberge et al. 2014).
209. As regards behavioural factors availability bias and myopia are examples often cited in literature as potential drivers of short-termism by corporate executives and portfolio

managers. Emphasis on short-term performance is likely to fuel availability bias, a human tendency to rely on information readily available. Moreover, under the influence of myopic loss aversion, a situation in which the focus is placed on a short-term horizon, corporate executives and investors may react too strongly to recent losses (Stein 1988; Stein 1989).

210. The literature suggests several options for aligning the time horizon of fund managers and corporate executives with the long-term interests of stakeholders. These include:

- A) Introducing or reinforcing a legal requirement on boards and fund managers to link executive and fund manager remuneration with the long-term sustainability of the firm (Salazar and Mohamed 2016; HLEG 2018).
- B) Senior executives and fund managers should consider the interests of the wider set of stakeholders including employees (Krehlmeyer et al. 2006).
- C) Having corporate and fund boards of directors exercise oversight of the degree to which corporate executives and fund managers engage in short-term decision making (CFA Institute 2008).
- D) Remuneration policy should ensure that both senior executives and fund managers have a material portion of their own wealth invested in the firm and fund, respectively (Krehlmeyer et al. 2006).
- E) Measuring investment fund performance against benchmarks that contain long-term investment metrics (Carney 2015).

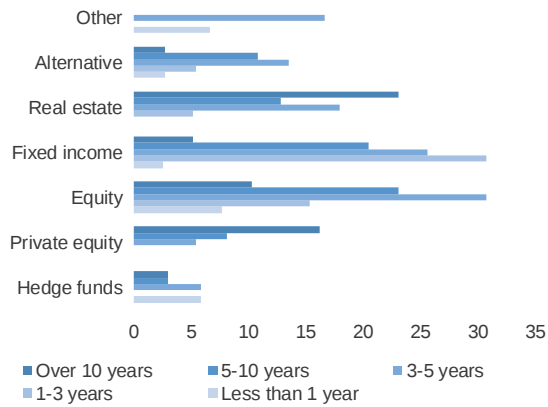
Public survey

211. ESMA notes that many of the responses received to this section of the questionnaire were not public. Nevertheless, all responses submitted to ESMA were taken into consideration for the analysis in this section, albeit on an anonymised basis.

Question 39

Table 25

Average investment horizon in funds



Note: Replies to the question: What is the average investment horizon of the funds managed by your firm? , (Q39), %
Sources: Public Consultation ESMA

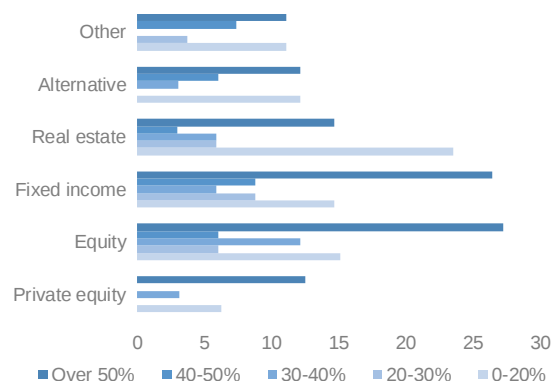
212. Question 39 invited respondents to provide input on the average investment horizon of their funds in order to aid the analysis of the findings by ESMA staff. Thirty-four respondents answered this question and clarified that the investment horizons are not the same for different types of funds. For instance, of those respondents who responded to the investment horizon of equity funds, the largest number (31% - 12 respondents) had a 3-5-year investment horizon, while for fixed income funds, the largest share (31% - 12 respondents) had a 1-3-year

investment horizon.

Question 40

Table 26

Average share of variable remuneration



Note: Replies to the question: in the salaries of identified staff of your firm's funds, what is the average share of the variable component compared to the fixed component? (Q40), %
Sources: Public Consultation ESMA

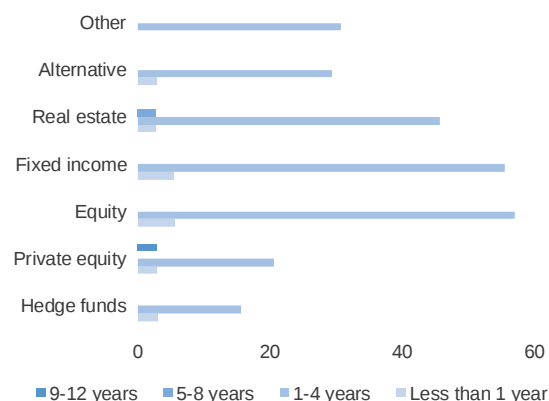
213. Overall, thirty respondents provided input to question 40. For two of the most common fund types, namely equity funds and fixed income funds around 27% of respondents (9) indicated that the variable component of remuneration for identified staff was over 50%. Hedge funds and alternative funds respondents were evenly split between the two extreme options of 0-20% and over 50%. Private equity respondents showed a slight majority for over 50% while real estate respondents reported a slight majority for 0-20%. Overall across all fund types, a slight majority of those

who responded indicated the variable component of identified staff remuneration is over 50%, while the second most popular option is at the other end, namely 0-20%.

Questions 41 - 43

Table 27

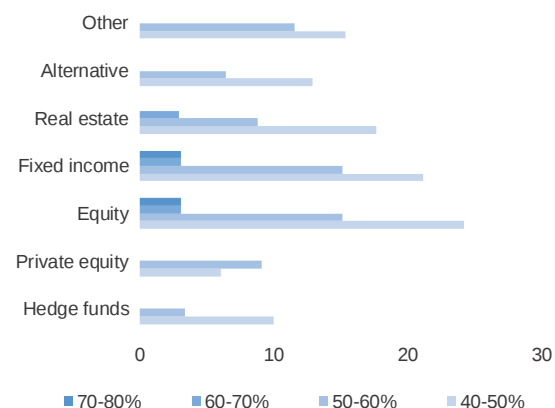
Variable remuneration reference period



Note: Replies to the question: Over what average time is the reference period for variable remuneration calculated for the identified staff of your firm's funds? (Q41), %
Sources: Public Consultation ESMA

Table 28

Average percentage of variable remuneration deferred

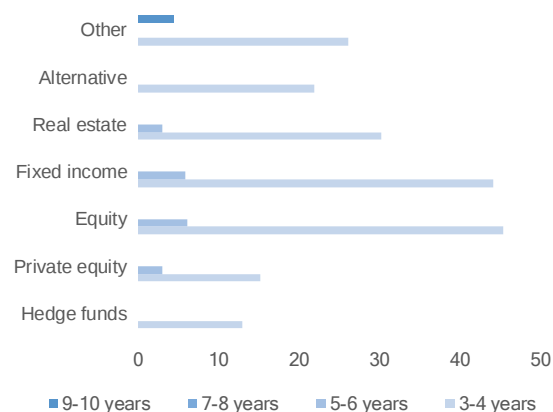


Note: Replies to the question: What average percentage of variable remuneration do you defer for identified staff of your firm's funds? (Q42), %
Sources: Public Consultation ESMA

214. Of the 32 stakeholders who responded to Question 41, in relation to the reference period for the pay-out of the variable remuneration, a significant majority of respondents indicated the time period to be four years or less (1-4 years). The majorities were striking in equity (57% - 20 respondents) and fixed income (56% - respondents) funds.

215. Regarding the average percentage of variable remuneration deferred that was requested in Question 42, a significant majority across all funds of the 30 stakeholders who responded to this question, indicated either 40-50% or 50-60%, while a handful of respondents indicate a deferral amount beyond 60% and up to 80%.

Table 29
Deferral period for variable remuneration



Note: Replies to question: on average, over what period do you defer the payment of the variable remuneration for identified staff of your firm's funds?, (Q43), %
Sources: Public Consultation ESMA

216. Finally, almost 90% of 31 respondents to Question 43 indicated that across all fund types payment of the deferred part of the variable remuneration is deferred by 3 to 4 years, while only a handful of respondents noted that such payment is deferred by 5 to 6 years.

217. It is worth noting, however, that a significant majority (from 54% to 72%) of respondents to questions 40-43 responded "not applicable" to all options, so the figures above are based on a fairly small sample size.

Question 44

218. In response to Question 44 regarding the potential existence of common practices in fund manager remuneration that contribute to short-termism 65% of the 46 respondents mentioned that they did not identify such practices.⁵⁵ The remaining respondents provided several reasons to explain their input. In these views, factors that are conducive to short-termism include reference periods for variable remuneration which are too short and the effects of peer group or benchmark pressure.

Advice from the SMSG

219. The SMSG noted the existing sectoral rules (UCITS Directive and AIFMD) applying to remuneration of fund managers in the EU. The group also pointed out that the recently agreed amendments to the SRD have 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. The SMSG did not provide input in relation to the remuneration of corporate executives.

⁵⁵ Percentages have been adjusted to account for two respondents who chose the 'yes' option in order to be able to provide justification to their 'no' responses.

Stakeholder workshop

220. By way of input to ESMA's presentation⁵⁶ on the findings of the survey, an industry representative noted that asset managers are remunerated based on a range of issues and performance is only one element of these.
221. Furthermore, speakers noted that deferral is a better tool to address short-termism concerns compared to measures on accrual periods during which the performance of the staff member is assessed for the purposes of determining their remuneration. Other speakers noted that despite fears that fund manager turnover was frequent, fund management companies are incentivised to minimise fund manager turnover because of the potential negative impact it may have on client loyalty.
222. Another participant raised the link between performance fees in investment funds and fund manager remuneration and suggested ESMA should also take these into consideration.

2.5.3. Analysis

223. ESMA notes that substantial remuneration rules for investment funds have been put in place in the past few years. Both the UCITS Directive and the AIFMD contain substantial provisions on remuneration policies that all UCITS management companies and AIFMs must implement.
224. ESMA has also issued substantively detailed guidelines for UCITS managers and for AIFMs on remuneration. The guiding principle of the legislative provisions and the guidelines is to align remuneration with risk and with the interests of underlying investors. The rules and the guidance are already designed to mitigate the kinds of short-termism issues raised by the HLEG report and call for advice by the Commission, for example by ensuring that the assessment process is based on the longer-term performance of the fund and its investment risks and that the actual payment of performance-based components of remuneration is spread over the same period.
225. ESMA also highlights that the framework in this area has been reinforced by the Sustainable Finance Disclosure Regulation which was published in the Official Journal on 9 December this year. This legislation contains a requirement on financial market participants (which includes fund managers) to publish a statement on how their remuneration policy is consistent with the integration of sustainability risks. ESMA believes that sustainability risks could include risks associated with short-termism and is therefore of the opinion that the application of the new rules should be monitored before embarking on further legislative changes.
226. ESMA furthermore notes that it has considered extending the scope of its survey to also cover individual portfolio managers remuneration rules, considering that the

⁵⁶ Please see presentation [here](#).

remuneration of staff involved in the provision of investment services to clients is a crucial aspect in terms of investor protection as firms should make sure that their remuneration policies and practices take into account conflicts of interest that arise in the provision of services to their clients, as well as MiFID's conduct of business requirements.

227. MiFID II has reinforced the rules for the remuneration of investment firm staff, which aim to ensure fair treatment of clients as well as avoiding biased behaviours (including undue pressure on short term results) and conflicts of interest in the relationships with clients.
228. In ESMA's view, though, the remuneration requirements set out in MiFID II, help address and mitigate potential practices of short-termism (e.g. focus on gaining monetary and non-monetary benefits at the expense of fair treatment of clients), which could arise from the remuneration of portfolio managers. For this reason, and also considering that the MiFID II regime has only recently entered into application, ESMA has not included this topic within the higher priority regulatory aspects in this report.
229. In the same context, ESMA takes note of the responses to the survey which show that, broadly, investment funds observe the ESMA remuneration guidelines by aligning remuneration to the risks in the fund and to the interests of the fund and investors.
230. ESMA points out that the survey showed that the most common reference period for the calculation of the variable component is relatively short, at 1-4 years. However, the accrual period should not be considered in isolation from the rules on deferral period and amount. The rules on the deferral period and deferral amount ensure that at least 40% of the variable remuneration that is earned is paid out over a long period of time (minimum three years).
231. Based on available literature and input from the survey and the stakeholder workshop, ESMA is not convinced that further action is warranted before the implementation and application of the SFDR. In line with the advice from the SMSG, the impact of SRD II may also be relevant to monitor.
232. ESMA is mindful of the resource implications for fund managers by the application of the remuneration rules and of a potential risk of over-regulation in this area. Therefore, ESMA proposes an approach that will first allow for the assessment of the rules that are or will be in place before undertaking further work. In ESMA's view the European Commission should observe the application of the SFDR in order to monitor potential effects of disclosing information about the consistency of remuneration policies with sustainability risks on countering any potential undue short-termism in relation to fund managers. ESMA stands ready to assist the Commission in its assessment of the SFDR rules and support it in potential future work in this area.
233. Regarding the points raised in the workshop on the link between performance fees and remuneration as a driver of short-termism, ESMA notes that it launched in July 2019 a

public consultation⁵⁷ on draft guidelines on the way in which performance fees can be charged to a UCITS fund and its investors while ensuring common standards of disclosure, as current practices vary among EU Member States. ESMA expects that the standardisation of those practices and in particular the proposal on the crystallisation of the performance fee over a minimum time period should improve the consistency between the investor holding period, the fund investment objectives and the manager's remuneration, promoting long-termism.

2.5.4. Advice

234. On the basis of the above considerations, ESMA sets out its advice on fund manager and executive remuneration below.

On the issue of fund manager remuneration, ESMA does not recommend immediate legislative action. ESMA believes that the Commission should monitor the effect of the SFDR 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 to address potential undue short-termism. In this case, ESMA stands ready to support the Commission if requested both in connection with the assessment of the SFDR rules and potential future work on this topic.

2.6. Remuneration of directors in listed companies

2.6.1. Existing regulatory framework

235. In the area of remuneration of listed companies' directors, the regulatory framework was recently modified by the entry into application of SRD II which provides for the content of the remuneration report for executive (and non-executive) directors. SRD II also provides for a shareholder vote on the remuneration report and on its consistency with the remuneration policy (which in turn is also subject to an advisory vote). To date, remuneration disclosure provided by listed companies varies across Member States and is based on national regulations and best practices.
236. One of the assumptions at the basis of SRD II provisions on directors' remuneration was that shareholders should be able to fully exercise their right to monitor corporates' long-term strategy and that remuneration is a key area for effective shareholder monitoring

⁵⁷ [ESMA34-39-881 Consultation Paper Guidelines on performance fees in UCITS, 16 July 2019](#)

as it has a material effect on managerial incentives. More in particular, Recital 33 of SRD II states that the disclosure of individual directors' remuneration and the publication of the remuneration report are intended to provide increased corporate transparency and accountability of directors as well as better shareholder oversight on directors' remuneration.⁵⁸

237. SRD II also emphasises that the remuneration policy should contribute to a company's business strategy, long-term interests and sustainability and should not be linked entirely or mainly to short-term objectives. Furthermore, according to Article 9 (a), directors' performance should be assessed using both financial and non-financial performance criteria, including, where appropriate, ESG factors, in order to balance some of the potential negative effects associated with a fully financial performance-related pay⁵⁹.

2.6.2. Evidence

Literature review

238. The remuneration of corporate directors, and in particular executive directors, is a traditional area of focus for academics. After the 2008 financial crisis, regulators increased their attention in this area and different approaches were developed to address the issue. The rationale behind regulating executive pay is connected to shareholders' interest in monitoring directors' risk-taking attitude and their effort to maximise long-term company value (Salazar and Mohamed 2015). In the absence of monitoring, executives may in certain circumstances use their discretion towards personal benefit and not necessarily in the interest of the firm and its shareholders (Bebchuck and Fried 2003).
239. Furthermore, because remuneration is often connected to short-term indicators such as annual and quarterly performance metrics, it is frequently argued that it may provide incentives to undertake more risky decisions in order to boost revenues in the short term, Salazar and Mohamed, (2015). Interestingly, Sanford et al. (1983) find that larger firms are more likely to focus on short-term incentives in their remuneration packages, which may indicate a correlation between industry structures and executive remuneration incentives due to different intensity of the principal-agent problem.
240. Especially in listed companies that often have a dispersed ownership structure, shareholders suffer from higher information asymmetries that make it challenging to monitor the alignment of the company's management with shareholder interests. In this context, shareholders tend to rely on remuneration as a tool to better link directors'

⁵⁸ For the purposes of this analysis, directors' remuneration was defined in line with the scope of application of SRD II, i.e. it refers broadly speaking to the overall remuneration, including all benefits, of the CEO, deputy CEO, board members and other persons who perform similar functions.

⁵⁹ Please see Recital 29 of SRD II. A long-term oriented remuneration policy is also endorsed by the [G20/OECD Corporate Governance Principles](#).

reward to measurable share value creation. The main tools to improve shareholders' monitoring on remuneration are: (i) disclosure, i.e. increasing transparency and improving the information available to investors, both ex ante and ex post; (ii) say on pay, i.e. facilitating shareholder voice by providing for (binding or non-binding) votes on both (ex ante) remuneration policies and (ex post) remuneration reports⁶⁰ (Bahar 2005).

- i) *Disclosure* of the way in which listed firms' directors are remunerated can traditionally be found in a variety of documents which are not necessarily very detailed nor consistent (Jackson 2006). To allow for an effective assessment, disclosure requirements should allow for comparability with both foreign and domestic peers as well as comparability across time. It is therefore crucial to improve standardisation of the metrics used to measure remuneration and the way they are disclosed (Bahar 2005).

However, the effectiveness of disclosure is heavily debated within the academic literature. Recent studies have shown that disclosure schemes can paradoxically lead to short-term incentives and cause the use of even more opaque and inefficient forms of remuneration (Barontini et al. 2013). Further, it may be difficult to define certain forms of remuneration, such as pension schemes and long-term incentives, which are not paid during the accounting year and thus may not be subject to disclosure (Bahar 2005). In addition, it is argued that remuneration disclosure correlates strongly with shareholder engagement only when a firm is closely held by a small number of shareholders with a dominant position (Craighead et al. 2004). Consistently with these points, McCahery et al. (2016) find that shareholders focus on a few proxies for the overall quality of the remuneration policy without properly considering the wealth of information provided to them on the executives' pay package and that shareholder focus on executive remuneration is more often found in long-term investors.

- ii) *Say on pay* is a key tool for shareholders to monitor (executive and non-executive) directors' remuneration (Thomas and Van der Elst 2014) and their incentives to focus on (long-term) company growth (Fisch et al. 2018). Overall, say on pay is found to encourage engagement among shareholders, as it provides them with a signalling tool to express their level of satisfaction with a firm's compensation strategy.

241. Such voting power may be twofold and can be distinguished into an 'ex ante' vote – focusing on the remuneration policy and therefore giving shareholders the possibility to influence the implementation and adoption of general remuneration policies – and the

⁶⁰ Further tools have been introduced in the financial sector, such as pay ratio caps, bonus bans and disclosure, which have been put in place to mitigate risk-taking and improve financial stability. However, this latter area falls outside the scope of this review.

‘ex post’ vote – focusing on the remuneration report, which breaks down the exact compensations assigned in a certain financial year. In this regard, Gerner-Beuerle and Kirchmaier (2018) find that shareholders tend to differentiate their voting behaviour between the ex ante and the ex post votes.⁶¹

242. Nevertheless, the effectiveness of say on pay in curbing remuneration excesses and the subsequent potential misalignment with long-term shareholders’ interests remains controversial, especially with reference to the comparative effectiveness of binding vs. non-binding votes (Harvey et al. 2019).⁶² While finding a moderate effect of say on pay on the level of CEO remuneration, HomRoy and Simmons (2016) also show that the introduction of say on pay laws has tended to restrain the equity (rather than cash) component of salary and its effect is stronger where these laws are binding rather than advisory.
243. Interestingly, shareholders do not appear to focus on director compensation unless the company is performing badly. Hence, as argued by Gerner-Beuerle and Kirchmaier (2018), the say on pay vote is, to a large extent, a say on performance. In this regard, Fisch et al. (2018) add that if shareholders are communicating concerns over short-term stock performance through their say on pay votes, they may be increasing directors’ incentives to focus on short-term stock performance rather than long-term firm value.⁶³
244. To conclude, the literature indicates that tools like remuneration disclosure and say on pay help mitigate monitoring costs by providing transparency on remuneration schemes to shareholders and by offering them a signalling mechanism. For this reason, several regulatory interventions in Europe and abroad have introduced these elements in the legal framework. As argued by Salazar and Mohamed (2016), such tools can effectively be fine-tuned to also tie executive compensation to the long-term sustainability of a firm and the interests of multiple stakeholders. Developing a more detailed metric or KPI of long-term company sustainability that captures multiple stakeholders’ interests could be crucial in employing these metrics and linking them with executive compensation, thereby ensuring better alignment between the principal and the agent also with regards to long-term sustainability.

Public survey

245. Through the public survey, ESMA sought to collect information on the relationship between remuneration of corporate directors and the long-term company strategy. In particular, ESMA collected evidence on the way executive remuneration packages are designed. Evidence on this aspect was expected to provide an indication of how

⁶¹ As for the first one, shareholders tend to express their disagreement on excessively high future remuneration packages, while the latter is used to point towards inefficiencies of remuneration packages and also as a tool to criticise poor corporate strategy.

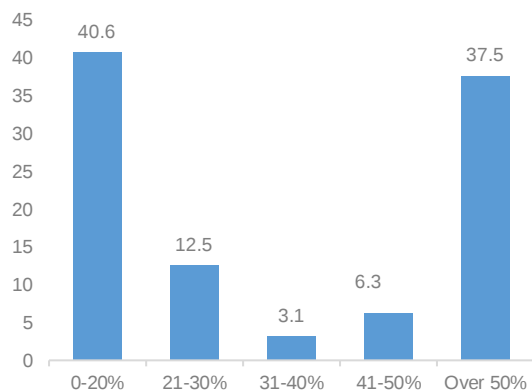
⁶² Balsam et al. (2016) report that shareholder vote on executive remuneration leads to a decline in pay levels or at least in CEO pay growth rates. Conyon (2015) also finds that the introduction of a binding vote on remuneration policies has led to declining rates of executive remuneration. See also Belcredi et al. (2014) and Iliev and Vitanova (2017).

⁶³ The relation between say on pay and performance remains controversial. For example, Cai and Walkling (2011) find evidence that say on pay can reduce firm value. On the contrary, Harvey et al. (2019) point to the weak empirical relationship that exists between corporate performance and executive remuneration. See Cai, J. and R.A. Walking (2007).

directors' incentives can be directed towards pursuing long-term vs. short-term performance.

Question 45

Table 30
Share of variable remuneration



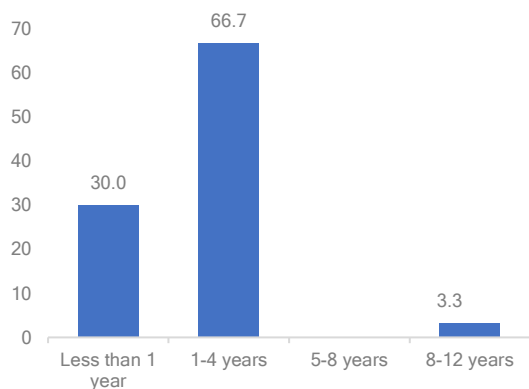
Note:: Replies to the question: in your firm, what is the average share of the variable component of executive remuneration compared to the fixed component?, (Q45), %
Sources: Public Consultation ESMA

246. Thirty-two respondents answered question 45 regarding the average share of the variable component of executive remuneration compared to its fixed component. Interestingly, the answers are concentrated on the extreme sides of the distribution: 53% of respondents (17) indicated that the variable remuneration is less than a third of fixed remuneration while almost 40% of respondents (12) indicated that it constitutes more than half of fixed remuneration.

Questions 46 - 47

Table 31

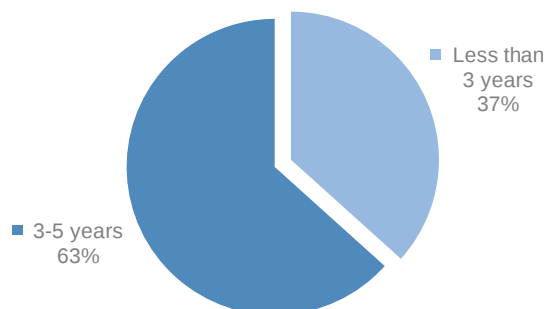
Over what average time is the reference period calculated for variable remuneration of your firm's executives?



Note:: Replies to the question: Over what average time is the reference period calculated for variable remuneration of your firm's executives?, (Q46), %
Sources: Public Consultation ESMA

Table 32

Over what average period is the payment of the variable remuneration of your firm's executives deferred?



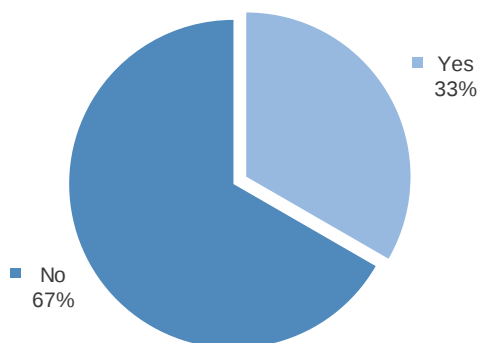
Note:: Replies to the question: Over what average period is the payment of the variable remuneration of your firm's executives deferred?, (Q47)
Sources: Public Consultation ESMA

247. Thirty respondents provided input to questions 46 and 47 in relation to the average reference period for the calculation of variable remuneration and the average deferral of payments, respectively. Responses concentrated in the lower part of the distribution. As regards question 46, almost all respondents stated that the reference period for the calculation of variable remuneration is either less than 1 year (30% - 9 respondents) or between 1 and 4 years (67% - 20 respondents). Responses to the second question indicated that payment is most often deferred by 3-5 years (63% - 19 respondents) or less than 3 years (37% - 11 respondents).

Question 48

Table 33

ESG-related objectives in variable remuneration



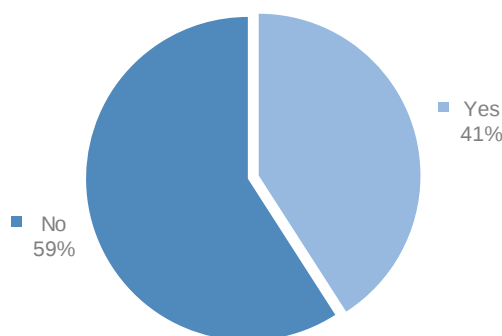
Note:: Replies to the question: is the awarding of variable remuneration to your firm's executives linked to any ESG-related objectives?, (Q48)
Sources: Public Consultation ESMA

248. Question 48 sought input on whether the awarding of variable remuneration to corporate directors is linked to any ESG-related objectives to which 33 stakeholders provided responses. In particular, one third of respondents stated that variable remuneration is linked to ESG-related objectives, while the remaining respondents did not indicate any such link. In this regard, some respondents commented that these objectives are part of companies' strategic targets, and

as such are included in their KPIs and therefore incorporated in their remuneration package.

Question 49

Table 34
Common remuneration practices contributing to short-termism



Note:: Replies to the question: do you believe there are common practices in the remuneration of corporate executives that contribute to short-termism?, (Q49)
Sources: Public Consultation ESMA

249. Finally, question 49 had a more qualitative nature and investigated whether any common practices in the remuneration of corporate directors that contribute to short-termism. 44 respondents answered this question out of which 41% argued that this is the case. Examples of practices that contribute to short-termism include mainly stock options linked to short-term value of the company's shares or to shareholder return based on an inappropriate peer group. Absence of malus or claw-back clauses and remuneration connected to short-term KPIs such as sales are also mentioned.

The remaining respondents did not

agree that specific practices in this area encourage short-termism.

Advice from the MSG

250. The MSG did not provide input in relation to the remuneration of corporate directors.

Stakeholder workshop

251. The discussion on the remuneration of corporate directors was centred around the following themes.
252. Firstly, it was observed that shareholders' say on executive remuneration is a useful monitoring tool and that design of remuneration packages might help align interests between investors and issuers. The increasing use of tools such as claw-back clauses is a step in the direction of limiting short-term bias. Further, the use of ESG factors for the purpose of setting remuneration packages can be an effective tool to provide management with the incentive to incorporate wider social costs into the company's strategy.
253. Secondly, it was argued that while there are several examples of managerial short-termism, there are also cases when executives have kept their firm going for too long despite decreasing ability to create value. In addition, it was indicated that some level of short-term bias is inevitable, especially in a volatile economic environment with

increasing technological changes. Finally, it was highlighted that managers do not necessarily respond well to incentive plans that are too long-term.

254. Thirdly, there was a discussion on different national experiences in terms of how the say on pay was implemented in different countries, highlighting that there is no consensus on which system works best and therefore it is acceptable to retain some flexibility across jurisdictions, although within the minimum harmonisation framework provided by the SRDII. It was also highlighted that the level of approval of remuneration items in annual general meetings (AGMs) is quite variable cross-country and cross-firm and several high-profile cases continue to come up. At the same time, it was pointed out that remuneration packages are often contested but generally get passed at the AGM and that overall listed companies' remuneration packages are less generous than in the financial sector, which may reduce their ability to attract highly-skilled management.

2.6.3. Analysis

255. As observed in the case of shareholder engagement, directors' remuneration is an area where the regulatory framework was recently revised and the goal and rationale underpinning the revisions clearly recognise the importance of reducing potential undue short-termism. In addition, the Commission is currently working on the guidelines that are to be adopted under Article 9(b)(6) of SRD II to specify the standardised presentation of the remuneration report as laid down in Article 9(b)(1).
256. Therefore, while a preliminary assessment would suggest that in line with the better regulation agenda there might be merit in further observing the overall impact of the SRDII before considering revisions, ESMA nonetheless sought information from stakeholders on how remuneration packages are designed and disclosed based on the current regulatory framework in the relevant Member States.⁶⁴
257. One key input coming from ESMA's call for evidence is that in some cases variable remuneration is linked to ESG-related objectives which in turn are often part of companies' strategic targets or KPIs. While this practice still looks more like the exception rather than the rule, it might be indicative of a growing trend in this direction. As such, ESMA is of the view that it is important to accompany the industry's self-regulatory efforts with adequate regulatory support to ensure that such practices are easily comparable cross-firms and cross-jurisdictions.
258. The draft guidelines for the standardisation of the remuneration report as published by the Commission in March 2019 take these aspects into due consideration. According to the relevant consultation paper,⁶⁵ *"with regard to long-term performance, the report*

⁶⁴ Please note that while the deadline for the entry into application of SRD II was on 10 June 2019, several Member States had not yet transposed the directive at that time. While the regulatory framework is still in progress, ESMA addressed this area as it is key to understand managerial incentives to pursue short vs. long term objectives.

⁶⁵ [Communication from the Commission, Guidelines on the standardised presentation of the remuneration report under Directive 2007/36/EC, as amended by Directive \(EU\) 2017/828 as regards the encouragement of long-term shareholder engagement, DG JUST/A.3, 1 March 2019](#)

should explain how the remuneration during the reported financial year has complied with the remuneration policy and contributed to the (specified) long-term interests and the sustainability of the company”. The draft Commission guidelines further elaborate on how the report could provide explanations in relation to the consistency between the criteria the company has used in its own remuneration policy, the performance achieved over the reported financial year and the outcome of the award resulting from each criterion in a way that allows to distinguish between one-year and multi-year incentives.

259. However, ESMA finds that providing an adequate level of standardised disclosure on the actual use of non-financial criteria can be challenging. In particular, references to non-financial criteria can often be too generic and the specific non-financial criteria adopted as well as the respective weight within the non-financial package and between financial and non-financial criteria are sometimes not disclosed. Other potential issues include providing clear quantitative targets for non-financial criteria, aligning the time horizon of targets and benefits and selecting criteria based on a materiality analysis.
260. In that sense, ESMA is of the view that it could be considered whether companies falling under the scope of the SRDII should be explicitly mandated to explain any deviations from the table⁶⁶ provided in the Commission’s guidelines to disclose how performance criteria included in the remuneration policy are applied. Under paragraph 6.5, indent 5, the draft guidelines allow companies flexibility in relation to disclosing the performance criteria and their application in the tabular format prescribed in the draft guidelines. This point, in ESMA’s view, may limit the usefulness of the information provided especially in relation to the application of the performance criteria. In particular, ESMA suggests that companies could be recommended to always fill in this standard table. In case they do not, they should provide adequate justification of why table-based communication was deemed not appropriate.
261. Coming specifically to ESG parameters, while it should be recognised that the market will need time to develop robust and comparable metrics, it is clear that ESG parameters are increasingly seen as standard KPIs to which remuneration can be linked. In perspective, ESMA suggests that the standardised presentation of variable remuneration could be further tailored to easily accommodate ESG criteria and, where such latter are not used, companies could be mandated to explain why ESG parameters are not suitable to their specific characteristics.
262. In addition, ESMA observes that the inherent flexibility that characterises the use of guidelines might reduce their ability to harmonise market practice across Member States. In this respect, ESMA finds that the standardisation of information disclosure is often an area where the use of tools such as technical standards are helpful to ensure comparable outcomes and improve consistency across the Union. As such, ESMA suggests that the Commission closely monitors the implementation and effectiveness of

⁶⁶ The table provides for a standardised disclosure of the following items: The performance criteria for each director, their weighting, information on min/max performance targets, measured performance and actual award outcome.

its guidelines and leaves the door open to considering the use of more binding tools should the guidelines fail to bring about the envisaged level of convergence.

263. Finally, ESMA notes that while market practice is likely to improve over time, this process might not lead to substantial improvements unless an efficient monitoring framework provides companies with adequate incentives to publish a high-quality remuneration report. Furthermore, ESMA observes that in several Member States information on directors' remuneration is not disclosed in the annual financial report but outside this document, possibly within the corporate governance report or even separately from this. Therefore, while the information on remuneration may be audited, it may not be subject to regulatory monitoring or oversight. On this basis, ESMA proposes that the Commission considers 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 subject to such duty.

2.6.4. Advice

264. On the basis of the above considerations, ESMA presents its advice to the Commission below.

ESMA recommends that:

- (a) In issuing the guidelines to be adopted under Article 9(b)(6) of SRD II, the Commission should consider recommending companies to make use of the standard tables provided for in such guidelines, unless they provide adequate justification of why table-based communication was deemed not appropriate. Furthermore, the Commission should consider whether the standardised presentation of performance criteria and their application could be further tailored to easily accommodate ESG criteria and require appropriate explanation when ESG criteria are not used. Finally, the Commission should closely monitor the implementation and effectiveness of its guidelines and consider the use of more binding tools should the guidelines fail to bring about the envisaged level of convergence. ESMA stands ready to assist the Commission in its assessment and support it in potential future work in this area.
- (b) The Commission considers requiring Member States to have an adequate independent monitoring framework to ensure the quality of information disclosed in remuneration reports published by companies.

2.7. Use of CDS by investment funds

2.7.1. Existing regulatory framework

265. The UCITS Directive lists financial derivatives as an eligible asset under Article 50. Indeed, Recital 43 says that *“UCITS should be expressly permitted, as part of their general investment policy or for hedging purposes in order to reach a set financial target or the risk profile indicated in the prospectus, to invest in financial derivative instruments”*. All eligible assets are further subject to the detailed rules in Commission Directive 2007/16/EC (the Eligible Assets Directive).
266. The use of derivatives is governed by specific rules for UCITS funds. Recital 45 of the UCITS Directive adds that *“[w]ith regard to over-the-counter (OTC) derivatives, requirements should be set in terms of the eligibility of counterparties and instruments, liquidity and ongoing assessment of the position. The purpose of such requirements is to ensure an adequate level of investor protection, close to that which they obtain when they acquire derivatives dealt in on regulated markets.”* Additionally, Recital 46 notes: *“Operations in derivatives should never be used to circumvent the principles or rules set out in this Directive. With regard to OTC derivatives, additional risk-spreading rules should apply to exposures to a single counterparty or group of counterparties.”*
267. The specific eligibility rules are set in Article 50(1)(g), points (i), (ii) and (iii). Risk management rules are laid out in Article 51, including the requirement that the use of derivatives is used for the purpose of efficient portfolio management and that *“under no circumstances shall [derivative use] cause the UCITS to diverge from its investment objectives as laid down in the UCITS’ fund rules, instruments of incorporation or prospectus.”* Furthermore, Article 51 states that a UCITS must ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio. Finally, the exposure has to be calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions.
268. Also relevant is Regulation (EU) No 236/2012 (the Short Selling Regulation), which aims to increase the transparency of short positions held by investors in certain EU securities. The regulation also reduces risks to the stability of sovereign debt markets posed by uncovered CDS positions, while providing for the temporary suspension of restrictions where sovereign debt markets are not functioning properly. Finally, the Short Selling Regulation ensures Member States have clear powers to intervene in exceptional situations to reduce systemic risks and risks to financial stability and market confidence arising from short selling and credit default swaps.

2.7.2. Evidence

Literature review

269. Derivatives play a fundamental role for investment funds that follow complex or so-called alternative strategies, such as hedge funds and synthetic index funds. The use of

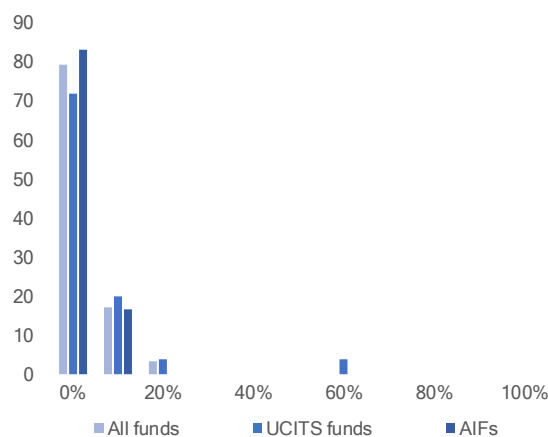
derivatives by European investment funds, and in particular by UCITS funds, is of particular interest for several reasons. Firstly, the EU UCITS market has experienced very strong growth since 2011, with fund assets increasing on average to reach around €10 trillion in 2019. Secondly, understanding how funds manage their portfolio risk remains a key objective from an investor protection perspective.

270. A first analysis of the EU derivatives market based on data under Regulation (EU) No 648/2012 (EMIR) shows that non-bank financial institutions engage in derivative transactions (Abad et al. 2016). Building on these initial findings, and further exploring EMIR data, Braunsteffer et al. (2019) provide a more granular mapping on the use of CDS by UCITS funds, building a sample of more than 18,600 funds comprising information on funds' domicile, strategy and NAV. In particular, they show that as of the end of 2016 7% of UCITS funds use CDS. These funds use a combined €387 billion in gross CDS notional, i.e. less than 5% of the EU CDS market. Fixed income funds and alternative funds are the main types of UCITS funds that participate in this market, with around 20% of the funds in these two categories (40% in terms of net asset value) using CDS, for a gross notional amount of €162 billion and €187 billion, respectively. Although the majority of funds using CDS seem to have limited exposure relative to their balance sheet (below 20% of their NAV), they find that for more than 100 funds the gross exposure from credit derivatives exceeds their NAV. Moreover, a non-trivial number of funds have gross exposure in excess of 500%.
271. Guagliano and Mazzacurati (2018), using a sample of 18,850 funds at the end of 2017 and information on derivatives from EMIR data, confirm that only a limited number of funds use CDS. In addition, they find that funds that are part of a large group are more likely to use these instruments; fixed-income funds that invest in less liquid markets, and funds that implement hedge-fund strategies, are particularly likely to rely on CDS; and fund size becomes the main driver of net CDS notional exposures when these exposures are particularly large. The analysis finally sheds some light on tail-risk from CDS for funds: directional strategy funds that belong to a large group are the most likely to have sell-only CDS exposures, exposing them to significant contingent risk in case of default of the underlying reference entity.
272. This recent empirical evidence suggests that the potentially elevated use of CDS by a portion of UCITS funds may lead to excessive risk taking and focus on short-term results. These results prompted the inclusion of this topic in the short-termism survey.

Public survey

Question 50

Table 35
Fund exposure to CDS



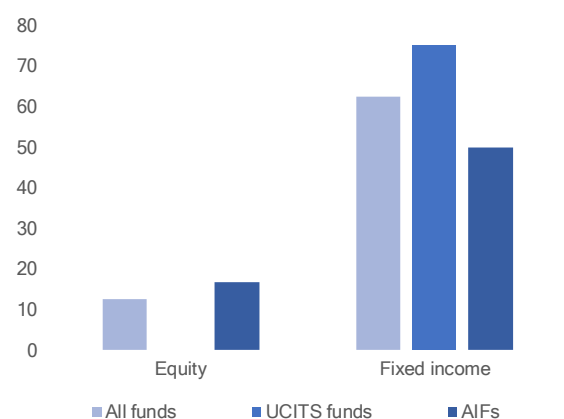
Note: Percentage of funds exposed to Credit Default Swap (CDS), (Q50), %
Sources: ESMA Public Consultation

273. In line with the recent empirical evidence, the majority of the 23 respondents who provided input to Question 50 noted that their funds had no exposure to CDS, namely 72% for UCITS funds (18 respondents), 83% for AIFs (20 respondents) and 79% for all funds (20 respondents). In terms of the number of funds exposed to CDS, 20% of UCITS respondents (5) indicated that such exposure was 10%, while 17% of AIF respondents (4) indicated it was 10%. Only one respondent indicated a 20% exposure for UCITS funds. Given these small numbers for exposure to CDS only very few respondents provided input to the subsequent questions 51

and 52. Considering that only a handful of stakeholders responded to these questions, such input was not considered helpful for the analysis of this topic.

Question 53 - 54

Table 36
Investment strategy of funds using CDS



Note: Primary investment strategy for funds holding sell-only or net-sell CDS positions, (Q53), %
Sources: Public Consultation ESMA

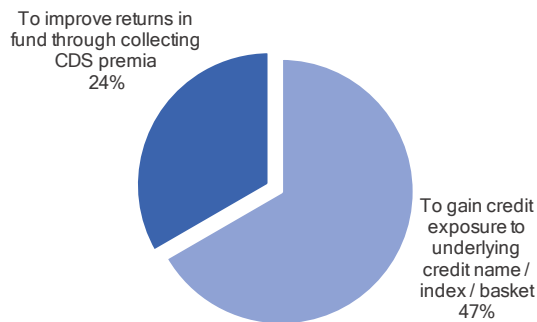
274. Eight respondents provided input to Question 53. On the basis of this input, it follows that the majority of the funds holding sell-only or net-sell positions in CDS are fixed income funds notably 75% for UCITS (6 respondents) and 50% for AIFs (3 respondents).

275. As regards Question 54 on the average size of holdings of 'net sell' or 'sell only' CDS, the seven respondents who provided input were split between below €1 million for all types of funds (43% - 3 respondents) and between €10 and €100 million for UCITS and AIFs (43% - 3 respondents and 33% - 2 respondents, respectively), with a few

responses indicating the range between €100 million and €1 billion.

Question 55

Table 37
Reasons for holding sell CDS positions

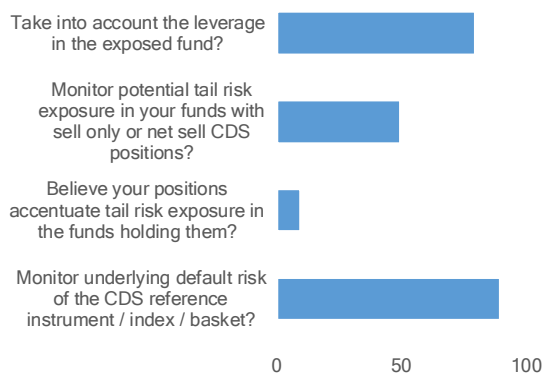


Note: Main reasons for holding sell-only or net-sell CDS positions, (Q55), %
Sources: Public Consultation ESMA

markets.

Question 56

Table 38
Risk management strategies



Note: Risk management strategies for funds holding sell-only or net-sell CDS positions (Q56)
Sources: ESMA Public Consultation

276. Seventeen stakeholders provided input to Question 55. According to 47% of these (8 respondents), the main reason for holding 'sell only' or 'net sell' CDS positions is to gain credit exposure to an underlying credit name, index or basket. For 23% of respondents (4 respondents) profit enhancing is the main driver of this strategy. These results are in line with the recent economic literature described in the previous section. Other drivers mentioned by respondents include liquidity management, index diversification and the higher market of CDS markets compared to the bond,

277. Ten stakeholders provided input to Question 56 with reference to risk management strategies followed by funds holding sell-only or net-sell CDS positions. 90% of these respondents (9) indicated they monitor default risk of the underlying instrument or index, 80% said they take into account the leverage in the exposed fund, and 50% of respondents (5) said they monitor potential tail risk exposure in funds with 'sell only' or 'net sell' CDS positions. In the additional qualitative input, many fund management companies underlined the regular use of strong risk monitoring practices.

Question 57

278. Lastly, several respondents mentioned other classes of derivatives that may contribute to undue short-termism in the economy, such as contracts for differences (CFDs). Others suggested that derivatives may contribute to both short-termism and long-termism.

Advice from the SMSG

279. The SMSG mentioned that they do not see a connection between the use of derivatives by investment funds and short-termism and questioned the singling-out of CDS specifically out of all the types of derivatives used.
280. Regarding the risk of CDS, the SMSG also noted that the Short Selling Regulation has already provided a regulatory response by banning naked short selling as well as naked sovereign CDSs. In addition, the Regulation introduced mandatory transparency in respect of net short positions.

Stakeholder workshop

281. ESMA presented the input received from the survey and the initial assessment regarding the use of CDS by investment funds.⁶⁷
282. One financial market participant representing an issuer association noted the common uses of CDS by all market participants: hedging exposures and achieving exposure. He also referred to the recent empirical evidence (Braunsteffer et al. 2019) suggesting a relatively low use of CDS by UCITS funds and reasons for selling CDS to achieve long exposure to securities with better liquidity.
283. An investment firm representative that CDS is an efficient hedging tool and a good selling opportunity when there is market volatility. Regarding the risk that increasing use of CDS-sell positions could lead to a lower demand for cash bonds, and thereby increasing short-termism in the economy, the representative did not see that use of CDS by capital markets would be a disincentive to issuance of bonds by companies, as the single name CDS market is relatively thin and only covers the largest issuers. Furthermore, exposure to CDS (2-5 years) tends to be shorter than cash bond market (10-15 years), so use of CDS should not impact demand for cash bonds.

2.7.3. Analysis

284. Recent empirical evidence suggests that the use of CDS by UCITS funds is limited, though some directional strategy funds that have sell-only CDS exposures and use CDS for short-term profit enhancing may be exposed to significant contingent risk in case of default of the underlying reference entity.

⁶⁷ The presentations are available [here](#) and [here](#).

285. The sample size in the ESMA survey is too small and the results obtained do not allow for any robust conclusion and support a hypothesis that a CDS exposure can be a significant driver of short-termism. ESMA will nevertheless continue to monitor this issue from a financial stability and investor protection perspective.
286. While concerns about potential tail risk in UCITS funds holding sell only or net sell CDS positions may be warranted, ESMA does not see sufficient grounds to recommend specific policy measures on CDS use by investment funds in the context of its short-termism advice.

2.7.4. Advice

287. On the basis of the above considerations, ESMA finds that it does not have the relevant basis which would allow it to make substantiated policy recommendations in its advice on the use of CDS by investment funds.

2.8. Other topics

288. This section sets out a summary of the input which ESMA received in relation to topics which it had not initially included in its study, but which some stakeholders deemed relevant to undue short-term pressures on companies. This input was received from respondents to ESMA's public survey, from the MSG and from participants in ESMA's stakeholder workshop. The summary of the input is followed by ESMA's analysis and feedback on the points that were raised.

2.8.1. Evidence

Public survey

289. Respondents provided input on a number of topics which ESMA had not included in the survey in response to Questions 58, 59 and 60. Twenty-seven stakeholders responded to Question 58 which invited additional input in relation to the topics covered in the survey, 28 stakeholders provided responses to Question 59 which asked for input on topics beyond those covered in the survey and 37 stakeholders responded to Question 60 which invited additional comments on the issue of short-termism. Many respondents took the opportunity to reiterate answers already provided or expand on their responses to previous questions. Where respondents commented on the topics addressed in dedicated sections of ESMA's survey, their comments are summarised under the corresponding section earlier in the report rather than here.
290. Several respondents provided general input on the topic of short-termism, explaining that it is a complex issue which encompasses a number of regulatory and policy elements. A handful of respondents indicated that they were not supportive of the approach reflected in the survey, while others provided specific suggestions for ESMA's consideration.

291. A number of respondents commented on the distinction between short- and long-termism, notably:

- Remarking that a short time horizon should not necessarily be labelled as problematic as it suits the needs of specific investors;
- Pointing out the difficulties of distinguishing between short- and long-term investing;
- Commenting on the difficulties of providing a definition to “long-term” and pointing out that while a certain correlation between the terms “illiquid” and “long-term” exists, liquid strategies are also geared to long-term success and provide sustainable returns.
- Warning that imposing additional requirements on long-term investors would have unintended consequences.
- Cautioning against developing an all-encompassing definition of long-term investment.

292. In relation to High Frequency Trading (HFT), ESMA was invited to distinguish between predatory practices and HFT activities that benefit end-investors which are legitimate elements of the market structure and help asset managers achieve best execution for their client. It was also suggested to ban HFT from EU capital markets because regulators incur significant costs supervising HFT activities and it has no economic value but sends the signal to market participants that short-termism can be a regular source of profit. Three issuer associations stressed that the rise of shareholder activism in Europe may to a certain extent go against the promotion of long-term value creation, as such activity may force companies to become overly focused on short-term financial performance. These respondents furthermore pointed out that activism may result in certain funds which are driven by short-term profit motivations using speculative methods, including short-selling coupled with massive securities lending and borrowing.

293. A number of respondents addressed the topic of quarterly reporting, which they considered to be linked to short-termism. One respondent commented that the reporting periods should be appropriate to the long-term nature of investments. Another respondent was of the view that quarterly reporting is a useful tool to inform investors about the development of the company and suggested that quarterly reporting should not be much less detailed than annual reporting, in particular for SMEs that are admitted to trading. One investor association presented a number of recommendations in order to overcome short-termism throughout the investment chain. These recommendations included, inter alia, the publication of long-term reporting guidance for companies, the publication of a stewardship reporting framework and the publication of a position paper inviting companies to stop the publication of quarterly reporting and short-term earnings guidance.

294. Lastly, a number of other topics were raised by individual respondents, notably:

- The reduction of financial research on SMEs as a result of the application of Regulation (EU) No 600/2014 (MiFIR), which makes the shares of smaller companies less attractive to investors;
- The appropriateness and suitability tests under MiFID II which the respondent considered establish strong barriers preventing small investors from investing in long-term products;
- Using retail investor education to address undue short-termism and using regulatory / fiscal incentives to ensure that investors maintain a long-term focus;
- The effect of human behavioural biases and cognitive shortcomings that present major roadblocks to recognising long-term risks and opportunities;
- A suggestion to improve the European Long-Term Investment Fund (ELTIF) regime by considering amendments in relation to eligible assets and investor eligibility rules;
- A proposal to train customer advisers from insurance companies and retail banks to address the issue of short-termism;
- A warning from an investor association that securities lending can place undue short-term pressure on companies when long-term oriented investors lend securities to short sellers that use the securities for short-term purposes. This respondent therefore asked for strengthened disclosure / governance rules for asset managers towards their end investors regarding lending practices;
- A suggestion from some members of an investor association that the scope of ESMA's report on short-termism should be enlarged to also cover the sell-side;
- A suggestion to align the recommended holding period (RHP) of PRIIPs with the nature of the product as well as allowing Pan-European personal pension products (PEPPs) to directly invest into capital markets;
- An observation from a stock exchange that financial regulation has been short-term oriented and put forward as example the requirements on asset managers under MiFID II for annual, quarterly and ad-hoc reporting to clients.

Advice from the SMSG

295. The SMSG suggested that a clear definition of short- and long-term investment rather than a time frame would be helpful. It also supported the development of specific criteria to assess the extent to which short-termism is problematic. Furthermore, the SMSG suggested further analysing:

- The impact of innovation and financial digitalisation, notably algorithmic trading, market making and HFT. The MSG argued that 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;
- Short-term pressure on target companies from groups of activist investors which may result in unsustainable dividends and slow down or postpone long-term investment.

296. In addition, the MSG pointed out that an early and continued financial and economic education plays a major role in consumers' preliminary understanding and comfort towards long-term financial instruments and underlined that the level of investor education is different across the EU.

Stakeholder workshop

297. Participants at ESMA's workshop commented on the preliminary findings of ESMA's study and suggested covering some additional topics. This input mirrored views expressed by respondents to the public survey as summarised in the previous section and related to topics such as the impact of a certain type of shareholder activist, the need for a definition of long-term investment and specific criteria regarding undue short-termism, the importance of financial education and the effect of HFT.

2.8.2. Feedback

298. This section sets out ESMA's feedback to the input summarised in section 2.8.1. above.

299. ESMA recognises that shareholder activism can be a mechanism to discipline companies and improve their performance while supervisors also need to be ready to act in cases of violation of regulatory requirements.

300. ESMA notes that at the EU level, the vast majority of activities in which wrongdoers using "shareholder activism" as a cover-up already fall within the scope of existing EU legal acts, such as the SRD, the Transparency Directive, the Takeover Bids Directive, MAR, the Short Selling Regulation and the AIFMD.

301. ESMA notes that the Transparency Directive and Takeover Bids Directive are minimum harmonisation directives and therefore, some rules are transposed differently across Member States. The Transparency Directive was revised in 2013 to address, inter alia, the issue of creeping control which could potentially be linked to shareholder activism. As regards the Takeover Bids Directive, Member States have broad discretion on the implementation of takeover rules which reflects the political sensitivity of public takeovers and the fact that public takeover bids are closely related to the civil laws of Member States. As regards the SRD, this was recently revised, and it is not yet possible to assess the impact of specific rules on the market.

302. As regards MAR, while it does not include specific provisions with respect to shareholder activists, it does address potential abusive practices which a significant shareholder may incur: as an example, the ban on insider dealing includes the prohibition of using undisclosed inside information obtained as holder of a stake in the capital of an issuer to make a financial gain, either acquiring or disposing financial instruments. It is also worth noting that the prohibition of market manipulation addresses the dissemination through the media or by any other means of false or misleading signals that would render the price of a financial instrument at an abnormal or artificial level.
303. On a related matter, it has been brought to ESMA's attention that some market participants consider that the obligations to disclose inside information under MAR may be conducive to short-termism as issuers are likely to make disclosures at an early stage of the decision-making process. While ESMA is not aware of systematic evidence substantiating the link between MAR and undue short-term pressures on issuers, it nevertheless points out that it has published a Consultation Paper on the potential review of MAR where, *inter alia*, the issue of inside information and its disclosure has been addressed.⁶⁸ In this regard, ESMA notes that should it receive conclusive evidence on this point, it will further consider it in the context of the MAR review.
304. On the topic of short selling, ESMA notes that in itself, short selling is a legitimate strategy subject to a number of obligations and constraints established in the Short Selling Regulation. Moreover, there does not seem to exist a clear link between short-selling strategies and the typical strategies of shareholder activists. Nonetheless, the Short Selling Regulation provides for a) prohibition of naked short-selling of shares; and b) transparency requirements, both towards regulators and the public. The transparency requirements set out by the Short Selling Regulation aim at reducing information asymmetries, ensuring that all market participants are adequately informed about the extent to which short selling is affecting prices. In that respect, thresholds are lower compared to the ones provided for in relation to transparency requirements for long positions.
305. In its technical advice to the Commission published in December 2017, ESMA concluded that the current reporting and transparency thresholds of notifications of net short positions should be maintained as they provide meaningful information to both regulators for supervisory purposes and the market for transparency purposes.⁶⁹ At the same time, ESMA recommended enabling national competent authorities to periodically publish anonymised aggregated net short positions on a voluntarily basis.
306. While ESMA appreciates the arguments by stakeholders regarding the impact of a certain type of shareholder activism, it does not believe that there is compelling evidence supporting that such activities contribute to short-termism. ESMA furthermore considers

⁶⁸ [ESMA70-156-1459 Consultation Paper MAR review report, 3 October 2019](#)

⁶⁹ [ESMA70-145-386 Final Report Technical Advice on the evaluation of certain elements of the Short Selling Regulation, 21 December 2017](#)

that the legal acts mentioned earlier in this section include transparency provisions in relation to the activities of shareholder activists and provide for different powers to NCAs to manage inadequate behaviour from market participants, including shareholder activists.

307. In that context, ESMA does not consider there are sufficient grounds to recommend a legislative amendment on this topic.
308. Furthermore, ESMA has considered the general arguments in relation to the impact of short-selling and securities lending practices and their potential link with short-termism. Nevertheless, ESMA points out that short-selling and securities lending are key for price discovery and market liquidity. Moreover, ESMA is not aware of concrete evidence pointing to a cause-effect connection between these practices and the existence of undue short-term market pressures. Additionally, the Short Selling Regulation foresees the right of NCAs and ESMA to adopt emergency measures that may even restrict the capacity of market participants to sell short financial instruments temporarily where a threat to the financial stability or to market confidence may exist.
309. ESMA is minded, therefore, not to recommend policy adaptations or changes in these areas, especially considering that the legislative framework provides for specific transparency requirements in the case of short-selling and securities lending. For example, under the ESMA guidelines on ETFs and other UCITS issues, UCITS funds provide transparency in their periodical reports and pre-contractual documents on the use of securities lending.⁷⁰
310. Moreover, in accordance with Regulation (EU) 2015/2365 (the Securities Financing Transactions Regulation or SFTR), and following the entry into force of the Commission Delegated Regulation (EU) 2019/356, market participants established in the EU and EU branches of third country entities operating in the EU are required to report detailed transaction level data on their securities lending transactions as well as on the reuse. The more specific aspects of reporting of plain vanilla and cash-driven securities lending transactions as well as the reporting of collateralisation on net exposure basis are covered by guidelines on reporting under the SFTR which ESMA is going to publish soon.
311. Lastly, in relation to the importance of the disclosure of securities lending activities to end investors, as the respondent noted, ESMA's guidelines on ETFs and other UCITS issues already require the disclosure of securities lending by UCITS to end investors. In relation to the point raised ESMA takes note of the recommendation to strengthen the existing rules and will take this into account in future considerations of the guidelines.

⁷⁰ [ESMA/2014/937 Guidelines for competent authorities and UCITS management companies Guidelines on ETFs and other UCITS issues, 1 August 2014](#)

312. ESMA considered the points raised by the SMSG and some stakeholders regarding the definition of short-term and long-term. While ESMA will consider this input for possible future work, it observes that the Commission's non-binding guidelines on reporting climate-related information⁷¹ state that the definition of short-, medium- and long-term is likely to depend on the company's business model and the life cycle of its assets and liabilities.
313. As regards the suggestion to develop criteria on what constitutes undue short-termism, ESMA has not found sufficiently robust evidence to recommend that such an exercise be undertaken. Furthermore, ESMA is not necessarily convinced that criteria would be useful to the market. ESMA will, however, monitor market developments and, if necessary, it may reassess its position on the matter for the areas that are within its remit.
314. ESMA paid careful attention to the comments regarding the role of financial education in allowing investors to actively opt for a more long-term outlook. ESMA believes in the merits of financial education, notably in the long term, as even the most robust rules have limitations if investors do not have at least a basic financial literacy. ESMA, therefore, takes note of these comments and will consider them for the planning of any future work on financial education.
315. As regards the comments on algorithmic trading and HFT (which is a subset of algorithmic trading), ESMA notes that under the MiFID II framework, co-legislators have decided not to prohibit algorithmic trading or HFT but rather to frame those activities and to address the negative impacts they can have on financial markets. In this context, MiFID II introduced a new set of provisions, e.g.:
- Access to information (regarding systems used, strategies deployed, etc.) is now regulated;
 - Firms undertaking HFT strategies need to be authorised;
 - Both HFT firms and trading venues need to have pre- and post-trade controls in place (testing of systems and algorithms, maximum order to trade ratio, etc.);
 - HFT firms undertaking market making strategies need to sign contractual arrangements with the trading venues where those strategies are deployed to ensure a minimum time presence;
 - Co-location services and fee structures should be fair and non-discriminatory;

⁷¹ [Communication from the Commission – Guidelines on non-financial reporting: Supplement on reporting climate-related information, C/2019/4490, 20 June 2019](#)

- New arrangements have been put in place to manage possible disorderly conditions (e.g. circuit breakers);
 - New provisions have been established to also address some indirect negative consequences of HFT and algorithmic trading on EU financial markets (e.g. harmonised tick size regime).
316. In addition, some trading venues are voluntarily putting in place new arrangements to mitigate the effects of HFT and algorithmic traders on their platforms and reduce their technological advantage (e.g. speedbumps).
317. Regarding the MiFID II provisions, ESMA is carefully monitoring their implementation and has already published guidance to ensure their effective and harmonised application. Article 90(1)(c) of MiFID II also requires ESMA to provide advice to the Commission on *“the impact of requirements regarding algorithmic trading including high-frequency algorithmic trading”*. ESMA intends to deliver this report by December 2020. The report will offer the opportunity (i) to undertake a broader review of the MiFID II framework regarding algorithmic trading and HFT; (ii) to analyse whether existing provisions are suitable and effective and, where appropriate, (iii) to make recommendations to the Commission to amend the existing regulatory framework.
318. Regarding the stakeholder that observed that financial regulation has been short-term oriented and used as an example the requirements on portfolio managers under MiFID II for annual, quarterly and ad-hoc reporting to clients, ESMA notes that there has not been any major change in MiFID II compared to MiFID I in relation to the provision of reports on services provided. The only exception is Article 30(1) which states that transactions with eligible counterparties are no longer exempt from applying Article 25(6) and one other amendment to clarify the requirement that reports should include “periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client”. In this regard, it is worth mentioning that investor protection should remain a key objective of EU financial regulation. In this context, it is important for clients to have access to regular information about their portfolios. ESMA also believes that, in line with MiFID II, it is appropriate for firms to report to clients when a loss of 10% of the initial value occurs (and thereafter at multiples of 10%). ESMA therefore disagrees with the comment raised and does not believe that specific changes to MiFID II are required on this topic.
319. In relation to the comment on the reduction of financial research on SMEs as a result of the application of MiFID II, which makes the shares of smaller companies less attractive to investors, ESMA notes that the Commission is already analysing this issue. As such, the Commission has recently launched a survey on the impact of the MiFID II unbundling rules on European investment research with a particular focus on corporate fixed income securities and SME equities. The survey will contribute to a study that is being prepared on this specific topic. ESMA therefore believes that while the topic is important, it goes beyond the scope of the present report on short-termism and is therefore not being addressed here.

320. As regards the comment that the appropriateness and suitability tests under MiFID II establish strong barriers preventing small investors from investing in long-term products, ESMA points out that the assessments of suitability and appropriateness are amongst the most important obligations for investor protection. The importance of these assessments for the protection of investors was already clear under MiFID I and has been confirmed and strengthened by the co-legislators in MiFID II. ESMA carefully reviewed the requirements when providing its technical advice to the Commission on MiFID II and MiFIR in December 2014 and has done further supervisory convergence work on this through guidelines and Q&As. ESMA does not believe that these requirements impose barriers preventing retail investors from investing in long-term products or that changes to the legal requirements are needed at this stage.
321. On the proposal to align the RHP in PRIIPs with the underlying product, ESMA mentions that this issue has been considered in the Joint Committee of the ESAs and has been addressed in Question 5 of the 4 April 2019 Q&A on the PRIIPs Key Information Document.⁷²
322. ESMA takes note of the request from one respondent to modify the level 1 requirements of the ELTIF Regulation on eligible assets and investor eligibility. However, ESMA underlines that the ELTIF Regulation was only enacted relatively recently and that there is not enough experience to determine whether the eligible asset or investor eligibility rules need to be reviewed.
323. As regards the comments in relation to the link between financial reporting and short-termism, ESMA is aware that some Member States require issuers to publish quarterly financial information under Article 3(1a) of the Transparency Directive and that some regulated markets also require the publication of such financial information. Nevertheless, ESMA echoes its response to the Commission's fitness check on corporate reporting,⁷³ under which quarterly reporting could not per se encourage short-termism. In its response, ESMA pointed out that there is no evidence that abolishing quarterly reporting would mechanically contribute to the promotion of long-term investment, a view which was shared by the majority of respondents to the Commission's fitness check.⁷⁴
324. ESMA agrees that the training of staff involved in the provision of investment services to clients is important to protect investors and to guarantee that clients' long-term objectives and needs are adequately taken into account. On this topic, ESMA notes that

⁷² [JC 2017 49 Questions and answers \(Q&As\) on the PRIIPs Key Information Document \(KID\), 4 April 2019](#)

⁷³ [Summary Report of the Public Consultation on the Fitness Check on the EU framework for public reporting by companies, Ares\(2018\)5582266, 31 October 2018](#)

⁷⁴ "The majority of respondents were of the view that abolishing the quarterly reporting requirement does not contribute to promoting long-term investment and long-term sustainable value creation and corporate strategies. Many of them did not see a significant link between quarterly reporting and the trend towards short-term business decisions and believed that the strategy of a company does not necessarily depend on the frequency of public reporting. A few respondents suggested alternative methods for promoting long-term investment and corporate strategies, such as introducing tax incentives to hold shares for longer periods."

it has already provided technical advice to the European Commission⁷⁵ that covered – amongst other things – changes to firms’ organisational requirements. In its advice, ESMA indeed stated that staff involved in the advisory process should possess skills, knowledge and expertise for the assessment of sustainability risks. ESMA therefore believes that on this topic, no additional changes are needed to MiFID beyond what was included in the 2019 technical advice.

325. In relation to the suggestion to extend the scope of the present report to cover the sell-side, ESMA observes that the new MiFID framework, which entered into application fairly recently,⁷⁶ has strengthened investor protection and improved the functioning of financial markets, making them more efficient, resilient and transparent. From its assessment of the MiFID II rules on the provision of the service of portfolio management, ESMA has not identified aspects of the rules that would unduly push service providers to focus on short-term performance over long-term growth. In addition, the European Commission is also finalising some changes to the MiFID II delegated acts on the basis of ESMA’s 2019 technical advice. These changes will require investment firms to integrate ESG considerations in their organisational requirements, product governance procedures and the suitability assessment. ESMA believes that, at this stage, no further changes to the MiFID framework are needed on this topic.
326. Lastly, ESMA appreciates the input of a more general nature regarding for instance the behavioural bias that is potentially conducive to short-termism or the suggestion to take into account long-term aspects when developing regulation. With respect to those comments, however, ESMA underlines that while they may be part of possible future considerations on this topic, it does not believe that they provide concrete basis to shape its current advice to the Commission.

⁷⁵ [ESMA35-43-1737 Final Report ESMA’s technical advice to the European Commission on integrating sustainability risks and factors in MiFID II, 30 April 2019](#)

⁷⁶ On 3 January 2018.

Annex I: Call for Advice from the European Commission

CALL FOR ADVICE TO THE EUROPEAN SUPERVISORY AUTHORITIES TO COLLECT EVIDENCE OF UNDUE SHORT-TERM PRESSURE FROM THE FINANCIAL SECTOR ON CORPORATIONS

With this Call for Advice, the European Commission invites each of the European Supervisory Authorities (ESAs) to develop a report presenting the evidence and possible advice on potential undue short-term pressure on corporations. The ESAs are expected to assess the extent to which short-termism is present and can be considered problematic. The ESAs should investigate potential sources of such pressure on corporates stemming from the financial sector. If evidence reveals significant issues, the Commission also invites the ESAs to assess whether these issues could be addressed by regulators and to provide advice on areas which regulators should address. The quality of the report should be adequate for the intended use as a basis for considering potential future policy options.

This request implements the action announced in the Commission Action Plan on Financing Sustainable Growth¹, building upon recommendations presented by the Final report of the High Level Expert Group (HLEG) on Sustainable Finance². The action will contribute to the aim of the Sustainable Finance Action Plan to foster transparency and long-termism in financial and economic activity by exploring possible drivers of undue short-termism. It will also indirectly address the aim of mainstreaming sustainability into risk management, as sustainability risks are typically of long-term nature and hence might be missed if investors focus on a shorter horizon.

The request is made in accordance with the founding Regulations establishing the ESAs³, which establish the obligation to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, including through ensuring the integrity, transparency, efficiency and orderly functioning of financial markets.

The reports should be based on qualitative, and, when feasible, quantitative sources. The initial evidence discussed in the reports can be based on representative data samples from public and commercial databases, data submitted to the ESAs by the supervised entities and qualitative sources of information, including a review of the most relevant literature. It may also include, but should not be limited to, concrete examples or case studies of undue short-termism, based on the experience of the ESAs in their supervisory capacity. The ESAs are also encouraged to engage with the most relevant stakeholders beyond the supervised entities. The scope of the reports shall be limited to pressures originating in the financial sector and those arising from financial sector regulation.

The need for this request and the scope of the work has been agreed between Commission staff and the ESAs. The delivery of the final report is expected by the end of Q4 2019. The Commission, in close cooperation with the ESAs, may revise and/or supplement this request and revise the timetable accordingly.

The European Parliament and the Council will be informed about this request.

This request will be available on the website of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union once it has been transmitted to the European Supervisory Authorities.

¹ https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

² https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

³ Regulations (EU) No 1093/2010, 1094/2010 and 1095/2010 of the European Parliament and of the Council

1. CONTEXT

Putting the EU economy on a sustainable path and managing the transition towards a low carbon economy requires that corporations consider and address relevant long-term risks and opportunities related to their business. Various studies suggest that decisions taken by companies today do not fully reflect these long-term aspects. One factor that may play a role in this regard is pressure from some shareholders, such as those who focus on short-term profit extraction and engage in activist voting. Meanwhile, some companies report that they are subject to short-term market pressures, which incentivise them to under-invest in long-term value drivers including innovation and human capital. Notably, investments that contribute to environmental and social objectives require a long-term orientation. Sustainability faces obstacles to develop in a context where incentives, market pressures and prevailing corporate culture prompt market participants to focus on near-term performance at the expense of the mid to long-term objectives.

Short-termism can be defined as “the focus on short time horizons by both corporate managers and financial markets, prioritizing near-term shareholder interests over long-term growth of the firm”⁴. Various studies refer to a focus on short-term performance in the corporate sector and suggest it may be also relevant for Europe. The Commission asks the ESAs to explore this area of concern in the EU financial sector. The overall objective of this request is to present an initial assessment of evidence on which potential future policy options could be developed, to establish whether or not short-termism in the financial sector presents a significant problem, evaluate the need for regulatory action and, in such case, propose specific areas which policy should address.

This request relates to Action 10 of the Sustainable Finance Action Plan that aims to foster transparency and long-termism in financial and economic activity by exploring possible drivers of undue short-termism.

2. SCOPE OF THE EXERCISE

The Commission invites the ESMA, EBA and EIOPA to investigate and collect evidence of undue short-term pressure from the financial sector on corporations and advise on possible further policy actions consider, if necessary, further steps based on such evidence. We invite each of the ESAs to assess, based on qualitative and, if feasible, quantitative evidence, whether there are such practices that generate undue short-term pressure within their remit and to produce a report summarizing these findings.

The scope of the report is limited to pressures originating in the financial sector (e.g. relation between investors/lenders and corporates, investor behaviour, capital market practices such as earnings guidance, possible effects of regulation on financial market participants).

The reports should include the following:

- 1) Initial evidence of undue short-termism (e.g. considering the evolution of asset holding periods in EU capital markets) in the respective remits of the ESAs, building on the conclusions of the relevant literature and an assessment of the extent of such short-termism is problematic. If feasible, the reports could also discuss the consequences of undue short-termism.
- 2) Assessment of possible drivers of undue short-termism suggested by previous literature, including earnings guidance or remuneration practices in the financial sector.

4 Mason, 2015

- 3) Identification of areas in existing regulations which contribute to mitigating undue short-termism and identification of areas where the rules exacerbate short-term pressures.
- 4) Recommendations building upon the evidence found, assessing whether there is a need for policy action and in which specific areas.

3. PRINCIPLES

The development of the report should be based on the following principles:

- **Autonomy:** The ESAs are free to choose an arrangement for their cooperation, which they consider most efficient to reach the objectives described in this request.
- **Reliable qualitative and quantitative data** should be considered to assess whether there is undue short-term pressure on corporates, subject to the availability of data. The report should be built on diverse, but unbiased sources.
- **Justified recommendations:** if the ESAs include recommendations to the Commission in the report, possible trade-offs with other EU objectives have to also be considered (for instance regarding sustainable corporate governance or market liquidity).
- **Coordination between the ESAs:** while three reports are requested under this initiative, ESMA, EBA and EIOPA need to closely coordinate their work on the reports. The reports should complement each other, in particular where significant cross-sectoral issues arise, and recommendations should not be contradictory.

4. STEPS AND TENTATIVE TIMETABLE

The report is expected by December 2019. In mid-September 2019, a draft featuring preliminary findings should be discussed with the Commission. The Commission will then consider ways to follow up on the report's findings, which may include policy action in this area.

The ESAs can choose the best way to approach the exercise in line with the scope and principles defined above. Due to the nature of the exercise, a close cooperation between the ESAs is highly recommended.

Step 1	Formal request sent	January 2019
Step 2	Collecting evidence and drafting the reports	January 2019 – December 2019
Step 3	Interim drafts and preliminary findings discussed with the Commission	mid-September 2019
Step 4	Discussion of pre-final reports	November 2019
Step 5	Final reports published	December 2019

Annex II: Papers used for literature review

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Annex III: Questions from ESMA's public survey

I. General information about respondent

1. Name of the company / organisation

[text box, max 200 words]

2. Type of respondent [drop-down list]

- ☐ AIFM
- ☐ Exchange or trading system
- ☐ Investment analyst
- ☐ Investor
- ☐ Investor association
- ☐ Issuer
- ☐ Issuer association
- ☐ Legal and accountancy
- ☐ Regulated market
- ☐ Self-managed UCITS investment company
- ☐ Standard setter
- ☐ UCITS management company
- ☐ Other

[text box triggered by selecting *Other*, max 200 words] Please specify

3. Industry [drop-down list]

- ☐ Communication
- ☐ Consumer
- ☐ Energy
- ☐ Financials
- ☐ Health
- ☐ Industrials
- ☐ Information Technology
- ☐ Materials
- ☐ Real estate
- ☐ Utilities
- ☐ Other

[text box triggered by selecting *Other*, max 200 words] Please specify

4. Are you representing an association?
 - ☐ Yes
 - ☐ No
5. Country [drop-down list]
6. Please indicate if you do not wish to have your response published on the ESMA website.

[tick-box with the following text] I do not wish my response to be published

7. This questionnaire considers long-term investment in the framework of sustainable finance, under the assumption that long-term investment projects should be consistent with the objective of supporting the shift towards a more sustainable financial and economic system. In this context, for the purpose of filling in this questionnaire, what timeframe would you consider when defining long-term investment?
 - ☐ 3-5 years
 - ☐ 6-10 years
 - ☐ 11-30 years
 - ☐ +30 years
 - ☐ Other

[text box, max 200 words] Please explain your response

II. Investment strategy and investment horizon

8. Which time horizon do you apply in your general business activities? Please tick one time horizon per row.

	Less than 1 year	1-4 years	5-8 years	9-12 years	More than 12 years	Not applicable
Overall						
- Business strategy						
- Profitability						
- Funding						
- Investment						
- Trading						

- Other						
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[text box triggered by selecting *Other*, max 200 words] Please mention your other activities and indicate the time horizon you apply to them

9. In your experience, to which extent are the following nodes in the investment value chain affected by the tendency towards short-termism?

	1: Not at all	2: To a small extent	3: To some extent	4: To a large extent	5: To a great extent
Retail investors					
Asset owners (i.e. giving the investment mandate either on their own account or on the account of retail investors)					
Asset managers (i.e. those in charge of fulfilling the mandate of asset owners)					
Top management of listed issuers					
Sell-side analysts					
Other					

[text box, max 400 words] Please explain your response

[text box triggered by selecting *Other*, max 200 words] Please mention any other nodes of the investment value chain that you believe are affected by the tendency towards short-termism and indicate the extent to which they are affected between 1 (Not at all) and 5 (To a great extent)

10. To which extent does each of the following factors result in short-termism by your institution?

	1: Not at all	2: To a small extent	3: To some extent	4: To a large extent	5: To a great extent
Macroeconomic environment					

Prudential regulation					
Market pressures					
Profitability					
Shareholders' interest					
Business objectives					
Competitive pressure					
Client demand					
Corporate reporting requirements					
Executive remuneration structure					
Other					

[text box, max 400 words] Please explain your response

[text box triggered by selecting *Other*, max 200 words] Please mention the other factor(s) that may result in short-termism by your institution and indicate their relevance between 1 (Not at all) and 5 (To a great extent).

11. What is the actual holding period prevailing in your investment strategy? Please respond on a best-effort basis and tick one holding period per category of securities.

	Less than 1 year	1-4 years	5-8 years	9-12 years	More than 12 years	Not applicable
Equity						
Bonds						
Other						

[text box triggered by selecting *Other*, max 200 words] Please mention the other categories of securities which you invest in and indicate the holding period you generally apply

12. To which extent does each of the following factors drive the actual holding period prevailing in your investment strategy?

	1: Not at all	2: To a small extent	3: To some extent	4: To a large extent	5: To a great extent
Profitability					
Shareholders' interest					
Competitive pressure					
Client demand					
Remuneration practices in the financial sector					
Economic activities					
ESG					
Monetary policies / macroeconomic factors					
Non-prudential regulation (e.g. tax regulation)					
Prudential regulation					
Corporate reporting requirements (any type of disclosure)					
Other					

[text box triggered by selecting *Other*, max 200 words] Please provide (qualitative) information on the holding period considerations within your investment strategy

[text box, max 400 words] Please explain your response

13. On a best-effort basis, in the next 2 years, how do you expect the average holding period of your portfolios to evolve? Please tick one holding period per category of assets.

	Increasing by less than 6 months	Increasing by 6- 12 months	Increasing by more than 12 months	No (notable) change	Decreasin g by less than 6 months	Decreasin g by 6-12 months	Decreasin g by more than 12 months
Equity							
Bonds							
Other							

[text box, max 200 words] Please provide any relevant information supporting your expectations.

[text box triggered by selecting *Other*, max 200 words] Please mention the other categories of assets which you invest in

14. To which extent will the expected evolution in the average holding period, indicated under question 13, be driven by each of the following factors? Please distinguish between equity and bonds

	Equity					Bonds				
	1: Not at all	2: To a small exten t	3: To some exten t	4: To a large exten t	5: To a great exten t	1: Not at all	2: To a small exten t	3: To some exten t	4: To a large exten t	5: To a great exten t
Profitability										
Shareholders' interest										
Competitive pressure										
Client demand										
Remuneration practices in the financial sector										
Economic activities										
ESG										
Monetary policies / macroeconomic factors										
Non-prudential regulation (e.g. tax regulation)										
Prudential regulation										
Corporate reporting requirements (any type of disclosure)										
Other										

[text box, max 400 words] Please explain your response and, if necessary, indicate any other types of securities you hold and the factors which drive your holding period for those securities

[text box triggered by selecting *Other*, max 200 words] Please mention any other factors which you believe will imply a change in the average holding period for your equity and / or bonds and indicate their relevance between 1 (Not at all) and 5 (To a great extent)

III. Disclosure on ESG factors and their contribution to long-term investment strategies

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".
- ☐ 1: Totally disagree
 - ☐ 2: Mostly disagree
 - ☐ 3: Partially disagree and partially agree
 - ☐ 4: Mostly agree
 - ☐ 5: Totally agree
16. [If response to question 15 is 1 or 2, respondents should see the following text and be able to tick one or more of the items in the list] 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? Please respond by selecting one or several items in the list below.
- ☐ Lack of sufficient independent assurance on the provided ESG disclosure
 - ☐ Lack of quantitative evidence regarding how the listed company contributes to national or international sustainability targets
 - ☐ Lack of consistency between the disclosed ESG policies and evidence of the listed company's actions
 - ☐ Lack of sufficiently forward looking-disclosure on ESG risks and opportunities
 - ☐ Lack of comparability between different listed companies' disclosure due to the Non-Financial Reporting Directive's disclosure requirements not being sufficiently detailed and allowing for the use of various disclosure frameworks
 - ☐ Lack of a clear link between ESG matters and the current and future performance of the listed company
 - ☐ Lack of an integrated presentation and analysis of financial and non-financial performance

- Lack of information on the disclosure framework(s) which listed companies use
- Lack of an explicit statement indicating that the listed company's Board of Directors takes responsibility for the relevance, accuracy and completeness of the ESG disclosure provided
- Lack of access to / availability of ESG disclosure in data aggregators or other source data providers
- Investors do not have sufficient knowledge on how to incorporate ESG disclosure into their decision-making process
- None of the above, non-financial information is not material to the investment decision
- Other

[text box triggered by selecting *Other*, max 200 words] Please specify

17. [if response to question 15 is between 3 and 5, respondents should see the following text and be able to select one or more of the options in the list] Why does disclosure of ESG information by listed companies enable long-term investment? Please respond by selecting one or several items from the list below.

- ESG disclosure provides insights into a listed company's long-term risk profile
- ESG disclosure provides insights into a listed company's future financial performance
- ESG disclosure complements the information provided by listed companies in their financial statements
- Other

[text box triggered by selecting *Other*, max 200 words] Please specify

18. [if response to question 15 is between 3 and 5, respondents should be able to tick one or more of the following boxes] 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. Please indicate to which extent each of the following factors may discourage investors from using ESG disclosure to apply a long-term investment horizon.

	1: Not at all	2: To a small extent	3: To some extent	4: To a large extent	5: To a great extent
Lack of sufficient independent assurance on the provided ESG disclosure					
Lack of quantitative evidence regarding how the listed					

company contributes to national or international sustainability targets					
Lack of consistency between the disclosed ESG policies and evidence of the listed company's actions					
Lack of sufficiently forward-looking disclosure on ESG risks and opportunities					
Lack of comparability between different listed companies' disclosure due to the NFRD disclosure requirements not being sufficiently detailed and allowing for the use of various disclosure frameworks					
Lack of a clear link between ESG matters and the current and future performance of the listed company					
Lack of an integrated presentation and analysis of financial and non-financial performance					
Lack of information on the disclosure framework(s) which listed companies use					
Lack of an explicit statement indicating that the listed company's Board of Directors takes responsibility for the relevance, accuracy and completeness of the ESG disclosure provided					
Lack of access to / availability of ESG disclosure in data aggregators or other source data providers					
Investors do not have sufficient knowledge on how to					

incorporate ESG disclosure into their decision-making process					
Other					

[text box triggered by selecting *Other*, max 200 words] Please mention any other factors which you believe 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?

- ☐ Yes
- ☐ No

[text box triggered by selecting *Yes*, max 200 words] Please explain why and indicate which types of intangible assets should be disclosed and which methods of valuation should be used

[text box triggered by selecting *No*, max 200 words] Please explain your response

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 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?

- ☐ Yes [should cause following text to appear] Please indicate which of the following approaches you consider appropriate:
 - Detailed disclosure requirements should be set out in an EU regulation (i.e. a piece of legislation which is directly applicable in all EU Member States)
 - Detailed disclosure requirements should be included in the NFRD (which is a directive and as such leaves it to Member States to transpose the disclosure requirements into their national law)
 - The NFRD should be amended to require use of a specific, binding disclosure framework (e.g. based on the principles included in the European Commission's guidelines on non-financial reporting or other established disclosure frameworks)
 - Other

[text box, max 400 words] Please explain your response

- ☐ No [should cause text box to appear, max 200 words] Please explain your response

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?

- Yes [should cause following text to appear] Please indicate which of the following approaches you consider appropriate:
 - The NFRD should be amended to require a broader group of companies to disclose ESG information;
 - The NFRD should be amended to require that ESG disclosure is audited by an external, independent entity;
 - Enforcement powers on ESG disclosures should be strengthened and made more consistent across the Union;
 - Other [should cause text box to appear, max 200 words] Please specify
- No [should cause text box to appear, max 200 words] Please explain your response

IV. The role of fair value in better investment decision-making

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”.

- 1: Totally disagree
- 2: Mostly disagree
- 3: Partially disagree and partially agree
- 4: Mostly agree
- 5: Totally agree

[text box, max 200 words] Please explain your response and provide evidence, where available

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”.

- 1: Totally disagree
- 2: Mostly disagree
- 3: Partially disagree and partially agree
- 4: Mostly agree

- 5: Totally agree

[text box, max 200 words] Please explain your response and provide evidence, where available

24. Is the current accounting treatment for equity instruments under IFRS¹ a decisive factor in discouraging a company from undertaking new long-term investments in equities?

- Yes
- No

[text box, max 200 words] Please explain your response and provide evidence, where available

25. Is the current accounting treatment for equity instruments under IFRS² a decisive factor in triggering divestment by a company of existing equity holdings elected for the long-term?

- Yes
- No

[text box, max 200 words] Please explain your response and provide evidence, where available

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? You may choose more than one factor.

- Volatility in reported earnings
- Measurement errors (in Level 2 or 3 Fair Value)
- Complexity of calculations (in Level 2 or 3 Fair Value)
- Management's opportunistic behaviour (in Level 2 or 3 Fair Value)
- Insufficient involvement of independent third-party assessment (in Level 2 or 3 Fair Value)
- Limited relationship with the expected developments of fair value in the long-term
- Other

[text box, max 200 words] Please explain your response and provide evidence, where available

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

² 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

V. Institutional investors' engagement

27. Is your investment strategy predominantly active or passive?

- ☐ Active
- ☐ Passive

[text box, 400 words] Please explain your response also in connection with the investment time horizon you have indicated under question 8.

Please respond to the remainder of this section based on (i) the investment strategy you have indicated under question 27 and (ii) the overall investment time horizon you have indicated under question 8.

28. Based on your response to the previous question, please elaborate on how the actual holding period of your investments matches with your investment mandate.

[text box, max 200 words]

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)?

- ☐ 1: Not at all
- ☐ 2: To a small extent
- ☐ 3: To some extent
- ☐ 4: To a large extent
- ☐ 5: To a great extent

[text box triggered by selecting 1 or 2, max 200 words] Please explain why long-term value considerations do not play a major role

30. To which extent does your firm integrate long-term value considerations for the purpose of setting its engagement policy (and subsequent engagement activities)?

- ☐ 1: Not at all
- ☐ 2: To a small extent
- ☐ 3: To some extent
- ☐ 4: To a large extent
- ☐ 5: To a great extent

[text box triggered by selecting 1 or 2] Please explain why long-term value considerations do not play a major role

31. How does your firm engage with the investee companies in order to mitigate potential sources of undue short-termism? Please select one or several options from the below list:

- ☐ Voting at the Annual General Meeting (AGM)
- ☐ Private engagement (bilateral meetings, conference calls, etc.)

- Collective engagement initiatives (coalitions, engagement platforms, etc.)
- Litigation (or a threat to use litigation as a negotiating tool)
- Other

[text box triggered by selecting *Other*, max 200 words] Please specify

[text box triggered by selecting more than one option, max 400 words] Please explain how you select different tools used for engagement

[text box triggered by selecting *Voting at the AGM*] Please respond to the following two questions [32] and [33]

32. [For respondents who chose option *Voting at the AGM* in Q31] What are the main AGM items your firm votes on in order to mitigate potential sources of undue short-termism?

- Remuneration of directors,
- Board appointments (including board diversity, independence, tenure),
- Related party transactions,
- Pay-out policy (dividends, share buybacks, etc.),
- ESG / sustainability-related disclosure,
- Other

[text box, max 200 words] Please specify

33. [For respondents who chose option *Voting at the AGM* in Q31] To which extent does your firm rely on proxy advisors for the purpose of deciding how to vote in order to mitigate potential sources of undue short-termism?

- 1: Not at all
- 2: To a small extent
- 3: To some extent
- 4: To a large extent
- 5: To a great extent

[text box triggered by selecting 1, max 200 words] Please explain why and indicate whether you have your own engagement team and, if you do, its size

[text box triggered by selecting 2, 3, 4 or 5, max 200 words] Please indicate from how many proxy advisors you obtain advice and indicate whether you have your own engagement team and, if you do, its size

34. Please indicate your agreement with the following statement: "Proxy advisors take into consideration long-term value when they provide voting advice".

- 1: Totally disagree
- 2: Mostly disagree
- 3: Partially disagree and partially agree

- 4: Mostly agree
- 5: Totally agree

[text box, max 200 words] Please provide quantitative or anecdotal evidence to corroborate your response

35. Please indicate your agreement with the following statement: “Engagement activities can be an efficient way of mitigating potential sources of undue short-termism”.

- 1: Totally disagree
- 2: Mostly disagree
- 3: Partially disagree and partially agree
- 4: Mostly agree
- 5: Totally agree

[text box, max 200 words] Please provide quantitative or anecdotal evidence to corroborate your response

36. To which extent do you consider your engagement activities successful in mitigating potential sources of undue short-termism?

- 1: Not at all
- 2: To a small extent
- 3: To some extent
- 4: To a large extent
- 5: To a great extent

[text box, max 200 words] Please provide quantitative or anecdotal evidence to corroborate your response

37. Which are the main obstacles that institutional investors face when engaging with investee companies, and how could they be addressed in your view?

[text box, max 400 words]

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”.

- 1: Totally disagree
- 2: Mostly disagree
- 3: Partially disagree and partially agree
- 4: Mostly agree
- 5: Totally agree

[text box, max 400 words] Please elaborate and explain which regulatory improvements could be considered, if any

VI. 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? Please select one investment horizon per category of fund.

	Less than 1 year	1-4 years	5-8 years	9-12 years	More than 12 years	Not applicable
Hedge funds						
Private equity						
Equity						
Fixed income						
Real estate						
Alternative						
Other						

[text box, max 200 words] Please specify

40. In the salaries of identified staff³ of your firm's funds, what is the average share of the variable component compared to the fixed component?

	0-20%	21-30%	31-40%	41-50%	Over 50%	Not applicable
Hedge funds						
Private equity						
Equity						
Fixed income						
Real estate						
Alternative						
Other						

41. Over what average time is the reference period for variable remuneration calculated for the identified staff of your firm's funds?

	Less than 1 year	1-4 years	5-8 years	9-12 years	More than 12 years	Not applicable
Hedge funds						
Private equity						
Equity						
Fixed income						
Real estate						
Alternative						
Other						

³ Defined in the Guidelines on sound remuneration policies under the UCITS Directive (ESMA/2016/575) and Guidelines on sound remuneration policies under the AIFMD (ESMA/2013/232).

42. What average percentage of variable remuneration do you defer for identified staff of your firm's funds?

	40-50%	51-60%	61-70%	71-80%	Over 80%	Not applicable
Hedge funds						
Private equity						
Equity						
Fixed income						
Real estate						
Alternative						
Other						

43. On average, over what period do you defer the payment of the variable remuneration for identified staff of your firm's funds?

	Less than 1 year	1-4 years	5-8 years	9-12 years	More than 12 years	Not applicable
Hedge funds						
Private equity						
Equity						
Fixed income						
Real estate						
Alternative						
Other						

44. TO ALL STAKEHOLDERS: Do you believe there are common practices in the remuneration of fund managers that contribute to short-termism?

- ☐ Yes
- ☐ No

[text box triggered by selecting Yes, max 400 words] Please explain your response and indicate which features of fund manager remuneration contributes 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?
- ☐ 0-20%
 - ☐ 21-30%
 - ☐ 31-40%
 - ☐ 41-50%
 - ☐ Over 50%
46. Over what average time is the reference period calculated for variable remuneration of your firm's executives?
- ☐ Less than 1 year
 - ☐ 1-4 years
 - ☐ 5-8 years
 - ☐ 8-12 years
 - ☐ Over 12 years
47. Over what average period is the payment of the variable remuneration of your firm's executives deferred?
- ☐ <3 years
 - ☐ 4-5 years
 - ☐ 6-7 years
 - ☐ 8-9 years
 - ☐ 10 years or more
48. Is the awarding of variable remuneration to your firm's executives linked to any ESG-related objectives?
- ☐ Yes
 - ☐ No

[text box triggered by selecting Yes, max 400 words] Please explain your response and indicate which share of variable remuneration is linked to ESG-related objectives

49. TO ALL STAKEHOLDERS: Do you believe there are common practices in the remuneration of corporate executives that contribute to short-termism?
- ☐ Yes
 - ☐ No

[text box triggered by selecting Yes, max 400 words] Please explain your response and indicate which features of corporate executive remuneration contributes to short-termism.

VII. Use of CDS by investment funds

50. What percentage of your funds are exposed to CDS? Please fill in the table with the applicable percentages and use 0 to indicate 'not applicable'.

	Percentage
All funds	
UCITS funds	
AIFs	

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'.

	Single name CDS	Index CDS	Basket CDS	Other
All funds				
UCITS funds				
AIFs				

[text box triggered by selecting *Other*, max 200 words] 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'.

	Sell only	Net sell	Net buy	Buy only
All funds				
UCITS funds				
AIFs				

53. If any of your funds hold sell only or net sell CDS positions, what is their primary investment strategy?

	Equity	Fixed income	Alternative	Other
All funds				
UCITS funds				
AIFs				

[text box triggered by selecting *Other*, max 200 words] Please specify which kind of CDS you are referring to

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.

	Below €1 million	€1 million ≤ X < €10 million	€10 million ≤ X < €100 million	€100 million ≤ X < €1 billion	Over €1 billion
All funds					
UCITS funds					
AIFs					

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 positions. [allow multiple options]

- ☐ To gain credit exposure to underlying credit name / index / basket
- ☐ To improve returns in fund through collecting CDS premia
- ☐ Other

[text box triggered by selecting *Other*, max 200 words] Please specify

56. If you hold sell only or net sell CDS positions in any of your funds, do you: [should be possible to select multiple options]

- ☐ Monitor underlying default risk of the CDS reference instrument / index / basket?
- ☐ Believe your positions accentuate tail risk exposure in the funds holding them?
- ☐ Monitor potential tail risk exposure in your funds with sell only or net sell CDS positions?

- Take into account the leverage in the exposed fund?
- Other

[text box triggered by selecting bullets 1-4, max 200 words] Please explain your response

[text box triggered by selecting *Other*, max 400 words] Please specify

57. Are there other classes of derivatives used by investment funds that could increase short-termism in the economy?

[text box, max 400 words]

VIII. Final

58. Do you have any additional input you wish to provide in relation to the topics covered in this survey? Please provide links to any relevant material / publications.

[text box, max 400 words]

59. Do you consider that any topics beyond those covered in the survey should be addressed in ESMA's advice to the European Commission on potential undue short-term pressures exercised by the financial sector on companies? Please provide links to any relevant material / publications.

[text box, max 400 words]

60. Do you have any other comments or thoughts on the issue of short-termism? Please provide links to any relevant material / publications.

[text box, max 400 words]

Annex IV: Respondents to ESMA's public survey

1	Securities and Markets Stakeholder Group
	Alternative investment fund manager
2	CGS CAPITAL D.O.O.
3	Union Investment Asset Management Holding
	Exchange or trading system
4	Deutsche Börse AG
5	Luxembourg Stock Exchange
6	Nasdaq
	Investment analyst
7	KBC Asset Management
8	Sofia International Securities JSC
	Investor association
9	Af2i Association française des Investisseurs Institutionnels
10	Assogestioni
11	CFA Institute
12	CFAVBA Society Netherlands
13	EFAMA
14	Eumedion
15	The Investment Association
	Issuer
16	Atlantic Grupa d.d.
17	BASF SE
18	Dassault Systèmes
19	Valamar Riviera d.d.
	Issuer association
20	AEM (Associação de Empresas Emitentes de Valores Cotados em Mercado)
21	Association Nationale des Sociétés par Actions (ANSA)

22	European Issuers
23	Quoted Companies Alliance
24	The ICMA Asset Management and Investors Council (AMIC)
	Legal and accountancy
25	KPMG
	Other
26	"Pension Assurance Company - Future" LTD
27	Actuarial Association of Europe
28	AFG - Association Française de la Gestion financière
29	AIMA/FMA
30	ALFI
31	Austrian Federal Economic Chamber, Division Bank and Insurance
32	AVIVA
33	AXA INVESTMENT MANAGERS
34	Baillie Gifford & Co
35	BETTER FINANCE (The European Federation of Investors and Financial Services Users)
36	BlackRock
37	BNP Paribas Asset Management
38	Boliden Mineral AB
39	Bulins JSC
40	Bundesverband Alternative Investments e.V. (BAI)
41	BVI
42	Caisse des Dépôts Group
43	CONCORDE INVESTMENTS (CYPRUS) LTD
44	Confederation of Swedish Enterprise (CSE)
45	ecoDa (European Confederation of Directors Associations)
46	Eika Asset Management
47	Eurelectric
48	European Association of Corporate Treasurers (EACT)
49	French Insurance Federation
50	Generali Insurance AD

51	groupama am
52	Individual
53	Individual
54	Individual
55	Invest Europe
56	IOGP (International Association of Oil & Gas Producers)
57	ISDA
58	Massachusetts Financial Services Company ("MFS") and its subsidiaries
59	MEDEF
60	Moody's Investors Service
61	Norwegian Securities Dealers Association
62	NOVO BANCO
63	Partners Group SK s.r.o.
64	Planet Life Economy Foundation
65	Preventable Surprises
66	PRVÁ PENZIJNÁ SPRÁVCOVSKÁ SPOLOČNOSŤ POŠTOVEJ BANKY, správ. spol., a. s.
67	Real Finance AD
68	Schelhammer & Schattera
69	Spainsif. Spanish Sustainable Investment Association
70	US Chamber of Commerce, Center for Capital Markets Competitiveness
71	Vanguard Asset Management
72	VBV Pensionskasse
73	VidaCaixa SAU
	Standard setter
74	SASB Foundation
	UCITS management company
75	ALLIANZ GLOBAL INVESTORS
76	Amundi AM
77	CaixaBank Asset Management, SGIIC, S.A.U.
78	Compass Invest JSC
79	DV Asset Management EAD

80	Eurizon Capital SGR
81	FFBH Asset Management
82	Invesco
83	LA FRANCAISE ASSET MANAGEMENT
84	Monyx Asset Management
85	NLB Asset Management, d.o.o.
86	Platinum Invest
87	Raiffeisen Asset Management Bulgaria EAD
88	Real Finance Asset Management
89	Schroder Investment Management Limited
90	Select Asset Management EAD
91	Sky Asset Management
92	Tatra Asset Management, sprav. spol., a.s.
93	UBB Asset management

Annex V: Advice from the SMSG

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 fulfill 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 fulfill 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 behavior 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 liked 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 behavioral 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.**

¹ COM(2018) 97 final.

² Definition according to second paragraph of section 1 of the Commission's mandate.

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.

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 behavior is more likely to favor 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 MSG 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 MSG 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 adaptations 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.

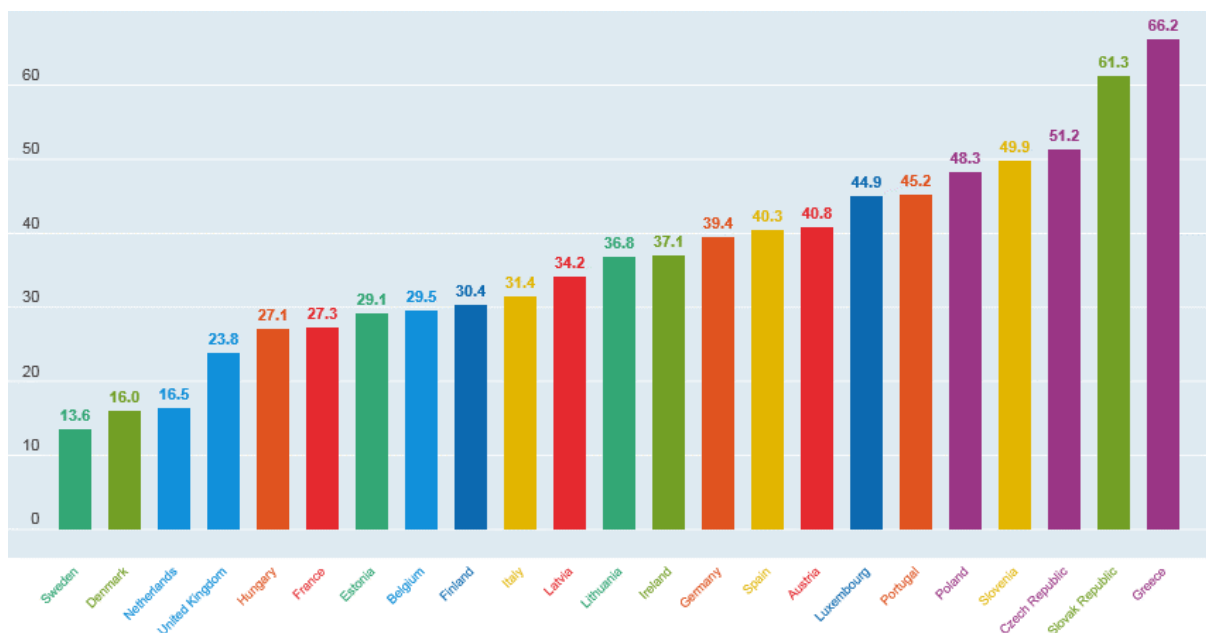
3. Investment Horizon and Investment Strategies (Section 2)

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 chart³ 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).

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”. MSG 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 behavioral 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 MSG 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 guidelines⁴ and Q&As on remuneration ensuring a consistent application of the framework and highlighting good and**

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

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.

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.

Adopted on August 15th, 2019

[signed]

Veerle Colaert



Chair

Securities and Markets Stakeholder Group