

ANOTHER STEP TOWARDS SUSTAINABILITY: ESMA CONSULTATION ON SHORT-TERMISM IN FINANCIAL MARKETS – WHAT ARE THE ISSUES FOR ASSET MANAGERS?

Another step has been taken towards fostering sustainable growth in the EU with the publication by ESMA of a survey on undue short-term pressure on corporations from the financial sector.

This development relates to Action Point 10 of the European Commission's Sustainable Finance Action Plan, which was published in March 2018. Action Point 10 focused on "fostering sustainable corporate governance and attenuating short-termism in capital markets".

In this briefing, we outline the key areas covered by the survey and some of the issues they may raise for asset managers.

Background

The Commission has previously commented that decisions taken by corporations do not fully reflect the long-term factors that would be required to put the EU economy on a sustainable path and that as a result of short-term market pressures, some companies may underinvest in the drivers of long-term value, such as innovation and human capital and overlook environmental and social objectives that require a long-term time horizon. Consequently, the Commission believes that there are obstacles to sustainability e.g. where incentives, market pressures and prevailing corporate culture prompt market participants to focus on near-term performance at the expense of mid-to long-term objectives.

The Commission issued a Call for advice to the European Supervisory Authorities on this topic in January 2019. The

current development is intended to inform ESMA's response to the Commission's Call for Evidence.

Key areas

ESMA has identified six areas which it considers relevant to examine:

- Investment strategy and investment horizons
- 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

Table 1 below summarises what the survey is seeking to ascertain in relation to each of the six areas and to which sector of the market the questions are directed. The survey is available [here](#).

Key issues for asset managers

The survey is relevant to asset managers and many of the questions are directed at, or relate to, that sector. Below we

Short Termism

"The focus on short time horizons by both corporate managers and financial markets, prioritising near-term shareholder interests over long-term growth of the firm"

highlight some of the key issues it may raise for asset managers.

Investment strategy and investment horizon

In section II of the survey, ESMA invites respondents to provide information on the key features and the focus of their investment strategy, as well as on the time horizon(s) they use in their business activities. ESMA's ultimate aim is to gain a broad understanding of how managers prioritise short- and long-term values in their investment activities. The range of responses is likely to vary significantly depending on the asset class and strategy of the relevant fund manager. For example, for funds that pursue a high frequency trading strategy, their investment activities are based on price movements as opposed to value, and so they necessarily have shorter holding periods than, for example, private equity fund managers. It will be interesting to see what sort of approach the

Commission adopts towards the more short-termist investment strategies as a result of this consultation.

Disclosure on ESG factors and the contribution of such disclosure to long-term investment strategies

Another section of the survey focuses on ESG disclosure and the contribution of such disclosure to long-term investment strategies. ESMA aims to investigate whether any changes, in addition to the Non-Financial Reporting Directive, are needed at EU level to enable investors to take long-term investment decisions. On the one hand, if the Commission were to take action to require more and/or better quality disclosure of ESG data this could be beneficial for fund managers, because the difficulty of obtaining quality and consistent ESG data is often cited as a significant challenge for managers and investors alike. For example, fund managers may currently be finding it administratively onerous to comply with their investors’ multiple bespoke ESG

reporting formats, and investors have cited issues with the inability to accurately benchmark their investments given the lack of harmonisation of data. On the other hand, although the Explanatory Note to the survey acknowledges that the text of the legislation which will clarify the disclosure obligations of asset managers in relation to sustainability considerations (known as the Disclosure Regulation) has reached political agreement, fund managers may well be hoping that any additional rules that the Commission may create as a result of this consultation do not result in duplicative requirements, especially when the proposed changes to AIFMD and UCITS with respect to integration of ESG factors are taken into account, as well as the close parallels with the disclosures required by the SRD II regime, and the UK FRC Stewardship Code.

Remuneration

ESMA aims to examine whether remuneration policies and practices of

fund managers are a driver of short-termism. The obvious potential issue for managers is whether the Commission, either in addition to or as part of the analysis of remuneration rules in connection with the AIFMD Review, will amend the various remuneration codes and/or guidelines applicable to AIFMs and UCITS managers to try and incentivise such managers to integrate ESG considerations into their reward packages in order to prevent short-termism.

Next Steps

ESMA will report to the EU Commission based on its findings by December 2019, in line with the Commission’s request to each of the three European Supervisory Authorities (ESAs). The report will present evidence and possibly advice on potential undue short-termism. The Commission will consider ways to follow up on the report’s findings, which may include policy actions.

Table 1: Survey aims and sector focus

Area of focus	Market sector to which the questions are addressed
<p>Investment strategy and investment horizon The focus of the questions is on the key features and investment strategies, as well as the time horizon(s) used in business activities.</p> <p>Aim:</p> <p>(i) to obtain comprehensive information on the strategic approach taken by various market players in order to get a broad understanding of how they prioritise short- and long-term values in their investment activities.</p> <p>(ii) to provide evidence on how consistent the long-term value drivers of the investment strategy are with the investment timeframe and the global approach for investment decision-making, and which specific considerations in investment strategies may induce short-termism.</p>	<p>All respondents.</p> <p>The questions relating to portfolio holdings are addressed to asset owners and asset managers.</p>

Area of focus	Market sector to which the questions are addressed
<p>Disclosure of Environmental, Social and Governance (ESG) factors and the contribution of such disclosure to long-term investment strategies Experience of market participants with disclosures under the Non-Financial Reporting Directive (NFRD).</p> <p>Aim:</p> <p>(i) to ascertain whether, how and to what extent public disclosure on ESG factors, can enable investors to integrate into their decision-making process considerations on a company’s current and future ability to create long-term sustainable value for its shareholders and for the society at large.</p> <p>(ii) whether any changes relating to requirements on non-financial information are needed at European level to enable investors to take long-term investment decisions.</p>	<p>Institutional and retail investors that make use of information in issuers’ public reporting in their investment decisions.</p> <p>Issuers that provide such ESG related information to investors.</p>
<p>The role of fair value in better investment decision-making Aim:</p> <p>(i) to collect further information related to the appropriate accounting treatment for long-term investments (mark-to-market or fair value?)</p> <p>(ii) To ascertain whether and 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.</p> <p>Responses in this area will help ESMA to assess how the measurement and disclosure of fair value may impact the selection of a short-or long-term horizon, as well as to assess whether the transparency benefits arising from the use of fair value for financial instruments, particularly equity instruments, outweigh the intrinsic potential volatility of fair value.</p>	<p>Institutional and retail investors that make use of information in issuers’ financial statements in their investment decisions.</p> <p>Issuers that prepare financial statements.</p>
<p>Institutional investors’ engagement (The questions in this section indirectly relate to the revised Shareholder Rights Directive that established specific requirements in order to encourage shareholder engagement in EU listed companies).</p> <p>Aims:</p> <p>(i) to ascertain whether and how institutional investors monitor the long-term value maximisation of their investee companies by further engaging with them and voicing their potential concerns.</p> <p>“Engaging” is defined 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 such as activist strategies.</p> <p>(ii) to collect information on how engagement activities are put in place in the Member States.</p>	<p>Institutional investors.</p>

Area of focus	Market sector to which the questions are addressed
<p>Remuneration of fund managers and corporate executives Aim: to examine whether remuneration policy and practices of fund managers can be a driver of short-termism.</p>	<p>Part A: UCITS management companies, AIFMs, and self-managed UCITS investment companies and AIFs.</p> <p>Part B: Issuers</p> <p>In addition, each section invites all stakeholders to comment on the potential contribution to short-termism from remuneration practices for fund managers or corporate executives.</p>
<p>Use of CDS by investment funds Aims: to collect information on the use of CDS by all investment funds.</p> <p>ESMA will use the information to assess whether the use of such instruments could be one of the potential drivers of short-termism.</p>	<p>UCITS management companies, self-managed UCITS investment companies and AIFMs.</p>

Further reading

- [Briefing](#): The EU Sustainable Action Plan: The New TEG Reports and EU Commission Guidelines
- [Briefing](#): The EU Sustainable Action Plan - an update report (April 2019)
- [Briefing](#): The EU's sustainable finance action plan: Clarifying Duties – What asset managers need to know
- Green and sustainable finance [Topic Guide](#) on the Financial Markets Toolkit

CONTACTS



Owen Lysak
 Partner
 T: +44 20 7006 2904
 E: owen.lysak@cliffordchance.com



Jacqueline Jones
 Knowledge Director
 T: +44 20 7006 2457
 E: jacqueline.jones@cliffordchance.com



Amy Watt
 Senior Associate
 Knowledge Lawyer
 T: +44 20 7006 1987
 E: amy.watt@cliffordchance.com

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www.cliffordchance.com

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London, E14 5JJ

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