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ecoDa's response to the EU Green Paper on Long-term financing of the European economy

The European Confederation of Directors' Associations (ecoDa) is a not-for-profit association based in Brussels, acting since March 2005 as the "European voice of directors". Through its national institutes of directors (the main national institutes existing in Europe), ecoDa represents more than fifty thousand board directors from across the EU member states. ecoDa's mission is to promote good corporate governance and improve the effectiveness of boards of directors and/or supervisory boards, particularly by means of appropriate director training, professional development and boardroom best practice. Consequently, ecoDa also paid attention to the interesting questions put forward in the Green Paper on Long-term financing. Given its mission, the questions addressed it its current response mainly relate to governance issues.

MAIN POINTS OF ATTENTION

1. The issue of short termism does not pose the same challenges throughout Europe. Countries with a wide dispersed shareholding base and very active stock markets (like the US and the UK) are apparently more vulnerable to short-term thinking than the continental European countries, which rely to a much larger extent on stable blockholders. This proves (again) that a 'one size fits all' approach is neither feasible nor relevant. Therefore, it is important that any remedy action is done in a proportionate way and not imposed to all countries in the same way. Opting for flexibility (comply-or-explain) is a valid solution to cope with European diversity.
2. Long-term financing starts with a sufficient layer of stable 'equity capital'. There is a growing consensus throughout Europe that listed companies need (to be able) to rely on long-term stable shareholders. ecoDa supports the idea that such shareholders will be able to perform a dedicated monitoring role because they will bring the necessary checks and balances any empowered board needs to be complemented with. The fact that the EU promotes a more in-depth reflection on possible incentives to stimulate such active long-term monitors is welcomed by ecoDa.
3. ecoDa hopes that the European Commission will thoroughly reflect on the conditions for stock markets to perform their crucial role in financing growth, certainly for SMEs. Further reflection on the paradox between the actual business models of stock exchanges (mainly built on a trading model anchored around velocity and liquidity) and the need for long-term stable shareholders deserves our full attention.

4. The EU focus on financing SMEs is warmly welcomed by ecoDa. Initiatives that help SMEs to make the transition to professional growth companies are badly needed in light of the economic turbulences Europe is confronted with. Facilitating funding of SMEs, particularly in their early stages of development, is probably one of the most effective means to further economic growth. Still, it is not the only answer to supporting the growth of SMEs. Professionalism is the most critical need for growth companies. To this end corporate governance might be promoted more actively as a necessary condition for facilitating SMEs to realise their growth ambition in a professional and sustainable way. ecoDa is convinced that a good governance track record (or rating) can facilitate the access to external capital, whether equity capital or other types of corporate financing (good governance lowers the risk profile and guarantees a focus on the corporate interest, leading to a better access to capital at a lower cost).
5. If rules might have side effects, the European Commission should anticipate them better and should look for alternatives and remedies (‘calibration’) certainly if such side effects become significant hurdles to long-term business success.

Q6: To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

Institutional investors, such as pension funds and insurance companies, have traditionally been important long-term investors, in line with the long-term character of their engagements. However their role has been quite different throughout Europe. Whereas in the UK stock market they were by far the most important shareholder category, the continental European countries relied more on other sources of long-term financing. The scenery changed quite drastically in the UK (see e.g. Kay Review, 2013), hence the wake-up call for more long-term thinking and more shareholder activism.

However, the investment by institutional investors is under pressure in all European stock markets due to regulatory restrictions (Solvency II, Basle III, and MIFID) as well as demographic evolutions (aging of the population leading to a net outflow of funds in pension funds).

ecoDa is grateful to the European Commission for putting the spotlight on the need for an in-depth reflection on the structural changes needed to restore the market for long-term financing in general and long-term equity more specifically.

Q 7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

ecoDa sees great merit in examining further the calibration of capital requirements and other financial regulation. New accounting and prudential regulations (IFRS, Solvency II, Basle III) are discouraging long-term financing (long term bank loans, project finance, equities…) and increasing the gap between long-term investment needs (for energy, infrastructures, research, innovation, …) and long-term capital, made available through banks, institutional investors, asset managers and capital markets.
Being close to corporate life and boards of directors, ecoDa is aware that the combined effects of Basle II, Solvency II and MIFID lead to a shortage of supply in long-term financing. The challenge is great in carefully balancing the benefits of a more robust regulation, aiming at less risky investments and a more stable financial sector, with the needs for a more diverse and long-term financing. Entrepreneurship and growth go hand in hand with risk taking and risky investments. What good is it to live a less risky society if no wealth is created any longer?

But there is also need for rethinking the position and role of the financial sector. The financial sector should be first and foremost at the service of the real economy. This supposes shifting gear from a focus on intra-financial business and trading-oriented strategies, back to the core of financing the real economy. This shift will hopefully also bring less systemic risk in the financial system.

Q 11) How could capital market financing of long-term investment be improved in Europe?

Boosting the availability of long-term funding through capital markets should receive high importance. According to the OECD (Mats Isakson, ecoDa conference 4.2.2013), there is a global shift, away from IPOs (SPOs representing 14 time the IPO volume in 2009) and away from the traditional OECD countries (with non-OECD countries serving 60% of all IPOs in the period 2008-

2011 and emerging markets representing 65% of the growth in global market cap). Different potential measures should therefore be considered.

First of all, we should carefully analyse to what extent the commercial stock exchanges and their business model are compatible with the aim of more long-term stable shareholders. In principle the business model of stock exchanges heavily relies on trading income. Today, equity market players focus more on frequency trading in large caps rather than on smaller market segments. ecoDa especially would like to stress the need for a better awareness of the side-effects of the actual model, making a plea for more attention for SMEs, which stock needs sufficient support and liquidity. Initiatives, such as the one taken by NYSE Euronext to create a pan-European entrepreneurial stock exchange deserve more attention.

Coping with High Frequency Trade is indeed an issue of importance. According to the OECD (Mats Isakson, ecoDa conference 4.2.2013), the huge increase in HFT has quite a number of negative consequences, such as: less attention for corporate fundamentals (from analysts to computer specialists), crowding out of long-term investment, concentration on larger companies, with as a consequence less liquidity in the smaller market segments and no interest any longer of analysts for smaller companies (less attractive, higher capital costs).

Another important point of attention is the promotion of long-term shareholders (see further question 21).

Q 12) How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

A first general remark is to be aware that more red tape might kill the attractiveness of the stock exchange all together, certainly for SMEs. The European approach should try to strike the right balance between securing trust in the financial system and the listed companies while at the same time limiting the additional barriers and bureaucracy involved in listing. The higher such barriers, the less attractive listing will become in comparison to other forms of external funding. Moreover there is the danger that politicians merely focus on what interests the media and the public at large the most, and neglect that corporate governance is far more than issues such as executive remuneration or gender diversity.

If one wants to promote long-term equity funding through capital markets, we will have to manage the short-term bias and this from several perspectives:

- ecoDa sees the upside of a smart, sustainable and inclusive economy that requires investments in long-term tangible as well as intangible assets. The latter assets are too often considered as expenses although they are key for European competitiveness (in a knowledge society).
- We need to develop a more long-term view on corporate performance, measuring short-term as well as long-term performance (e.g. the balanced score card) combined with a view on financial as well as non-financial performance.
- ecoDa would like to make a plea for a more nuanced and integrated approach towards non-financial reporting. First, we need to harmonise various non financial reporting initiatives: sustainable development report, Intellectual Capital report, integrated reporting. Secondly we need to be well aware of the hurdles to overcome: such reporting comes at a considerable cost

and any obligation should be proportionate and well thought through (with extensive cost/ benefit analysis). Such analysis should take all potential limitations into consideration, such as difficulties of measuring qualitative or forward-looking aspects (there is no IFRS equivalent for NF reporting), respecting business secrecies while clearly defining responsibilities (board of directors, auditors, etc.). The tendency to limit the ESG transparency to a number of key indicators is promising in this respect.

- ecoDa wants to further promote the use of enterprise risk management information, to integrate the potential downside of short-term optimisation initiatives.
- In order to stimulate a long-term focus of the company it is good to further promote the alignment of management remuneration with long-term value creation.
- Also the promotion of employee share ownership can help in this respect. In certain Member States (like France), employee share ownership has proven to be a viable route for aligning the interests of the corporation and the employees shareholders, while at the same time promoting the long-term sustainability of corporations.
- ecoDa would like to recommend maintaining the obligation to publish quarterly reports, but the condition should be that the format of such quarterly reporting should be more flexible, permitting less comprehensive reporting while emphasizing much more the long-term aspects of performance. In such a way ecoDa hopes not to lose the benefits of a globally appreciated system of regular business updates, while discouraging investors and companies from an excessive focus on short-term 'noise', which is not indicative of fundamental business trends. To completely turn back on this point would in ecoDa's opinion involve a significant step back in governance standard. It would open-up for increased speculation, risk-taking and insider trading, and it would further shrink the "windows" open for insiders to buy and sell shares in their companies.

Finally, ecoDa would like to point out that transparency has reached its limits (see also Kay Review in the UK) as far as listed companies are concerned. Two elements deserve further attention in this respect: there seems to be a never ending tendency to increase the disclosure requirements for listed companies (see again the EU action plan on transparency of diversity in all of its aspects, on shareholders, on non-financial performance). However, there is no clear indication of the value added of such avalanche of information (for an in-depth reflection on this issue, see the Kay Review in the UK). Secondly we should also not ignore that transparency might have negative side effects. Illustrative in this respect is that remuneration disclosure facilitated benchmarking, with an upside spiral as a consequence. Therefore, the European Commission should critically check any new transparency requirements for listed companies. However, ecoDa acknowledges that more transparency might be necessary with respect to specific capital market parties and transactions, such as the so called "shadow finance" and security platforms or transactions.

Q 20) - To what extent do you consider the use of fair value accounting principles has led to ST in investor behaviour?

An element that has not gained great attention up till now is the potential unintended side-effect of fair value accounting for the distribution of 'apparent' profits to management (variable remuneration) as well as shareholders (dividends/share buy backs). In times of economic successful times and (potential) market bubbles, the financial reports may present a rosy picture, allowing all those receiving a variable remuneration to take advantage of the 'apparent' capital gains.

Q: 21) What kind of incentives could help promote better long-term shareholder engagement?

A first point of attention is to what extent shareholder engagement can be 'enforced'. Comparing the corporate law on shareholders versus directors, it immediately becomes clear that whereas a shareholder may behave as an opportunist or an egoist, this is not allowed at all for a member of the board of directors. Consequently ecoDa is convinced that shareholders cannot be obliged to play a stewardship role. It is only when such monitoring role is in their own interest that they will decide to get actively involved in corporate stewardship.

With great caution, it will be necessary to explore reasonable ways to solve the 'collective action problem[1]' by facilitating action in concert certainly for important minority shareholders, like institutional investors. More attention to the promotion of shareholder engagement through additional transparency on stewardship and voting will also be key. Regular dialogue between investors and enterprises, not only once a year at the AGM, is also relevant.

However, it is doubtful that such measures will solve the famous free riding syndrome[2] of dispersed shareholders. Other incentives seem necessary.

- One of such incentives could be the promotion of long-term stable and active shareholders by attributing special rights to LT shareholders (voting rights, dividend rights, special bonus share issues), proving that engagement delivers a positive cost/benefit ratio. Notwithstanding the traditional opposition against insider shareholders, recent academic research clearly revealed that stable as well as concentrated ownership outperforms the dispersed shareholder model (e.g. during crisis periods). In the absence of shareholder activism, 'ownerless capitalism' creates a vacuum of stewardship (with huge executive remuneration as evidence) and a focus on the ST (see e.g. Cox report in the UK). However, controlling shareholders in general and differentiated voting rights more specifically need to be complemented with additional safeguards for protecting minority rights (protecting against private benefits and related parties' transactions)! Illustrative in this respect might be the situation in countries like Slovenia, where major shareholders, having the power to influence decisions at general meetings, are attributing themselves royal dividends, hereby taking out all of the profit from the companies. Some countries with controlling shareholders show the way how to better protect minority shareholders (e.g. Belgian regulation on related parties' transactions)..
- Another incentive can come from a more favourable tax regime for LT-shareholders (according to the UK proposal Cox this is the most beneficial treatment, given that such measures might have quicker effect than special rights for LT shareholders). Lower capital gains taxes would increase the motivation and capacity of individual investors to accumulate capital, thus lowering the cost for companies to acquire equity. Moreover, through lower tax rates for longer holding periods, investors can be given incentives to retain their investments for a longer time.

[1] Dispersed shareholders are faced with a collective action problem. It is difficult to find a way for different (competing) investors to collaborate in order to gain sufficient influence over a company in which they both (all) have shareholdings. Moreover there is the legal problem of 'acting in concert', which leads to an obligation to make a public take-over bid, in case a combined shareholding of 30% of capital cooperates to control the company.

[2] The free riding problem states that investors with small investment percentages have little incentive to spend cost and effort on governance since passive investors in the company will also benefit from their efforts at zero cost and hence outperform the active ones.

- Another route could be to rethink voting rights in case of takeovers (shares having only voting rights until held for a minimum of, say one year or building up of voting rights progressively, over a number of years; see Cox Report UK).

Before granting any specific incentives, it is important to get a careful impact analysis and to get a balanced position and sufficient support among stakeholders. The European Commission should keep in mind that it is important to have different kinds of shareholders in listed companies. In countries with dispersed shareholding structures, it might be advisable to stimulate long-term and stable blockholders/shareholders. The opposite holds for countries with a more concentrated shareholding structure, where the attention might be how to insure sufficient liquidity and correct valuation of the companies. In systems with controlling shareholders there might be more need for installing sufficient protection for minority shareholders as well as making sure such insidersrespect the requirements of professionalism and good governance practices.

Directors should take into consideration the corporate interest but also the interest of all shareholders and stakeholders. In fact, it happens from time to time that the shareholders' interests and the corporate interests differ (e.g. dividend payments versus internal financing of large investment projects).

Q 23) Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

Fiduciary duty is essentially a concept of Anglo-Saxon law stating that board members have a duty of loyalty to shareholders. In continental Europe, particularly in countries like France, Germany, and Belgium, priority is given to the corporate interest, which includes shareholders' as well as stakeholders' interests. From this perspective one could conclude that it is a complex matter to come to a common definition at European level.

However ecoDa would like to point to the fact that fiduciary duty should be interpreted from a much broader perspective, than merely director duties. The concept should be enlarged to include also the duties of investors and asset managers as well. If asset owners feel that it is their legal duty to simply maximise short-term performance against a benchmark, then this short-term demand will be transmitted to fund managers and subsequently companies. However, if the fiduciary duty of investors is also about promoting long-term performance, this could also have implications (via the investment chain) for the temporal pressures facing companies.

Combining both aspects, ecoDa considers it of importance to examine the type of incentives that are created by the legal/fiduciary duties of both directors and investors, and consider if they need reform.

Q 24) To what extent can increased integration of financial and non-financial information help stakeholders to get a clearer overview of the LT performance, and contribute to better investment decision-making?

See question 12

25- Is there a need to develop specific long-term benchmarks?

For a more general reflection on this question, we refer to our reply on question 12.

Besides the classical factors, one could also integrate some fundamental governance elements to make sure the company is run with emphasis on the corporate (long-term) interest and continuity at heart (see also questions on SMEs)

> Q 26) What further steps could be envisaged in terms of EU regulation or other reforms to facilitate SME access to alternative sources of finance? ....

The focus on financing of SMEs is very important, as the new banking regulations will have serious effects on the banks' possibilities to finance SMEs.

A first, more general remark is that scale is a relative notion. When focusing on the SME market, we should take stock of the huge difference in the structure of the capital markets and the scale and market cap of listed companies. What is considered a mid-cap in Germany may well be a large cap in Belgium. For listed as well as unlisted companies, there is the EU definition of SMEs that could be used as a reference.

The barriers to entry for listing as an SME could be decreased if the corporate governance framework would be less approached from a formal compliance perspective and much more with a best fit in mind. ecoDa would like to make a plea for paying more attention to the tailoring of governance to the needs and challenges of the company, while emphasising less the formal compliance exercise (box ticking). ecoDa believes that the EU should give more attention to the flexibility offered by the comply-or-explain regime. Best practices have often been defined by reference to the larger blue chip companies. Those 'standards' are less adapted to the companies in the micro/small and even mid-cap markets, let alone the non-regulated segments of the capital markets. Best fit should be the ultimate objective, and not universal adoption of standard best practice for large companies. Research into what constitutes VALID explanations and ALTERNATIVES might be very useful for those market segments. According to this philosophy, corporate governance structures and procedures should be compliant with the basic principles of good governance while leaving the company with the responsibility to prove to the outside world that its practical implementation and fine tuning fits the company's strategy, ambitions, specific circumstances and challenges. The starting point of a good governance framework is to make sure that the governance arrangements support the business model (Paul Moxey, ACCA; ecoDa conference 4.2.2013). Only when we have reached this stage will European governance represent a key component of a competitive European business environment.

Besides listing, one should also look at alternative funding, such as private equity. In a UK report (Cox 2013), the proposal is launched for developing a funding escalator for growth companies (financing the successive stages of development from start-up to large-scale corporation).

Based on the same report, we would like to emphasize that: 'To develop, smaller companies need guidance and mentoring as well as finance. Simply making more funding available is an incomplete answer.' Therefore, ecoDa would like to make a plea for further promoting that governance for unlisted companies can be a guarantee for a more objective and professional running of the business in the interest of the corporation (managing private benefits, checks & balances, transparency and accountability) as well as with the long-term continuity in mind (pro-actively managing succession of founder, owner, ...). It is important for SMEs -as they grow in size and complexity- to pursue increasingly active and professional board work, including outside directors (a development for which, incidentally, the ecoDa member organisations are particularly well-placed to play a pivotal role). ecoDa has promoted specific recommendations on CG for unlisted companies, which could

gradually be applied to strengthen their competitiveness and attractiveness in the period before an IPO (http://www.ecoda.org).

> Q 28) Would there be merit in creating a fully separate and distinct approach for SME (capital) markets? How and by whom could a market be developed for SMEs including for securitised products specifically designed for SMEs' financing needs?

Different visions exist as to the best approach for promoting an easier route towards equity (and bond) funding for SMEs through the capital market. The pro's and con's need to be further studied, including the following points of attention

- SMEs do attach special interest to staying in control and consequently they often are reluctant to listing because of their fear of 'completely losing control'; more attention should be paid to a system, whereby they can gradually open up to external capital (using e.g. mechanisms that honour long-term stable shareholdership, such as differentiated voting rights).
- More attention should be paid to the professionalism in management and governance that should be installed, quite a time before going to the stock exchange (see also the reply on Q 26); also on this point a gradual evolution process is far better than an abrupt revolution with independent directors holding a majority in important board committees (or even in the full board as a recent UK suggestion proposed for listed companies with a controlling shareholder).