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Advice to ESMA

Own Initiative SMSG Report II on Covid-19 related Issues

Introduction

The Covid-19 pandemic has had tremendous effects on our societies. The loss of lives is counted in hundreds of thousands and the number of confirmed cases in millions. As societies have closed down to limit the spread of the disease, economic activity has ground to a halt. A secondary effect may therefore be to produce the most severe economic crisis since the Great Depression.

As the Covid-19 virus has started to spread throughout the world, the impacts on the real economy through lockdowns and other measures are indeed starting to unfold with unprecedented magnitude. Markets have been resilient despite high volatility and the consequent strong fluctuations of valuations and liquidity.

This advice will give an early view on lessons from the crisis on the basis of experiences of financial industry and investors in different segments of capital markets and indicates a need to re-equitise the economy. Given the dynamic developments of the health and economic crisis and the reaction of capital markets, there is a need to closely continue coordinating between all stakeholders, ESMA and NCAs on how to best react to the crisis as it develops further and to establish the right conditions for stronger EU capital markets.

I. Lessons from the crisis

A. *Operating in a contingency plan modus is expected to become a normalised operational mode for certain teams*

1. The global health crisis implies that on average almost the entire workforce is working from home (WFH), all front to back teams are impacted across the globe. A return to the pre-crisis operations is likely to be very progressive and subject to stop-and-go.

2. WFH has become a new way to conduct business in backup continuity mode, i.e. when other solutions were not adequate or available. While the switch was challenging at times, WFH has also shown very positive aspects such as higher efficiency, flexibility and effectiveness for certain tasks and issues as well as better work-life-balance for some. The work environment is expected to radically change, including for those who conduct regulated activities,

who in many cases are expected to maintain their work from home capacity on a more permanent "Business as Usual" basis, requiring market participants and regulat0ors to adapt to this new reality.

B. *A need for regulatory coordination in regard of short selling*

3. The Short Selling Regulation enables NCAs to introduce restrictions aimed at tackling specific adverse circumstances that constitute a serious threat to market confidence. The assessment of the situation, the initiative and specification of the measure are at national level and ESMA is asked to provide an opinion on whether the local measure is necessary. To this end, ESMA considers the measure, its appropriateness, proportionality and duration.

4. The SMSG acknowledges the important role of short selling in price discovery, market efficiency and liquidity provision. There are different views in the SMSG as to whether short selling bans in this crisis were counterproductive or useful. One view is that especially in adverse circumstances and highhighly volatile markets short selling activity is very important for price discovery, liquidity provision and market efficiency. Another view is that short selling bans in a crisis situation provide protections to issuers and investors. The SMSG agrees, however, that there is need for common interpretations of the applicable rules on the basis of which national authorities may issue short selling bans and a common interpretation of what constitutes short selling.

5. The SMSG advises that ESMA should conduct a consultation and report to the Commission on suggested improvements to the framework on emergency powers. In absence of such emergency powers for the time being, ESMA and NCAs should agree on a pragmatic, harmonized approach to be used in the future.

II. Asset Management

A. Strongly restricted primary and secondary market liquidity & liquidity risk management

6. Investment Funds experienced difficulties due to restricted primary and secondary market liquidity, especially in bond markets, despite the massive intervention of central banks on secondary ones, while equity and foreign exchanges market continued to function. Funds only function when underlying markets function. See in respect of market liquidity parts IV and V below.

7. Liquidity tools (swing pricing, gates, notice periods, side pockets, suspensions, etc) are useful to deal with liquidity risk while ensuring fair treatment of all investors. Their availability and implementation is encouraged by IOSCO. Nevertheless, these tools are not all available in all European jurisdictions. The SMSG encourages ESMA to strive to more supervisory convergence in the application of efficient liquidity tools.

8. Another tool to deal with liquidity risk management are liquidity stress tests. ESMA's Guidelines on liquidity stress testing in UCITS and AIFs issued in September 2019 for application by September 2020 are welcomed. However, their translations to the other European Union

languages are not yet available and thus the NCAs have not yet implemented the necessary legal changes in the national texts. The SMSG therefore urges ESMA to make available translations of the guidelines as soon as possible to help all European members states in their work to improve liquidity stress tests.

B. ESG Package disclosure 10 March 2021, ESG risks

9. SMSG members from the asset management industry have indicated that the current crisis puts pressure on risk managers, which are less available to work on the project of new developments regarding sustainability risks. Sustainability risks disclosure obligations require that sustainability risk assessments need to be operationally tackled by March 2021. There are currently no guidelines yet on how asset managers may deal operationally with sustainability risks and data from issuers will not be available on a comparable format until the Non-financial Reporting Directive (NFRD) will be amended and applicable. Some SMSG members would therefore prefer an extension of deadlines in this respect. Other members do not want to put the EU’s sustainability agenda in jeopardy because of the current crisis.

10. The SMSG is in any event of the opinion that further guidelines on how to implement the sustainability risks disclosure obligations should be a matter of priority.

III. OTC-Derivatives Markets

A. ESA actions in respect of margins for non-cleared derivatives

11. On April 3rd, BCBS-IOSCO announced support for a 12 months delay to the compliance schedule for Bilateral Margining requirements of non-centrally cleared derivatives (to September 2021 and September 2022 respectively). This delay has been implemented in EU law by Joint-ESA Regulatory Technical Standards (“Margin RTS”) for EMIR, published on May 4th. The SMSG welcomes this EU alignment with the global implementation timetable.

12. The final report amending the Margin RTS also formalizes the proposed extension of derogations for cross-border intragroup transactions and for equity options. However, these are proposed to expire on 20 December 2020 and 4 January 2021 respectively. The SMSG asks clarity from the ESAs to market participants as to supervisory expectations at the end of this period.

B. ESA actions required in respect of EMIR Refit reporting of trades with NFC-clients

13. EMIR Refit requires dealers to report on behalf of Non Financial Clients (NFC- clients) OTC derivatives transactions to Trade Repositories. Financial counterparties require certain information from small non-financial clients to enable such reporting and may need to sign a new reporting agreement. This is required across thousands of relationships. Certain SMSG members argue that the current 18th June implementation date is untenable due to crisis-induced

constraints on legal, compliance, IT and operational staff. The result could be that NFCs- would be cut off from market access if all of this is not in place on 18 June.

14. The SMSG notes that ESMA indicated on May 12th that it “does not believe that deprioritising supervisory actions in relation to the provisions in question is an adequate way forward”, and so coordinated ex-ante relief is not expected at this stage. In certain cases firms might be confronted with non-compliance of reporting liabilities due to factors outside of their control (e.g. the NFC- client has not transferred trades between TRs), and in such cases NCAs may elect to provide relief at the Member-State level. ESMA should remain attentive to the risk of fragmentation in the provision of services to NFCs during the post-implementation period, which is expected to be in a period of extended crisis-related constraints on operational resources.

IV. Functioning of Debt Capital Markets

A. Very active high-grade primary market only following central bank QE support

15. In the primary markets, the extreme volatility in the last week of February secondary market activity was severely disrupted with liquidity drying up and essentially shut down the primary markets for about 14 days, curtailing new issue activity. However, the progressive and substantial central bank action, particularly the reintroduction and expansion of the ECB’s Quantitative Easing measure and the announcement of the new Pandemic Emergency Purchase Programme (PEPP) on 18 March, was instrumental as the catalyst to restart the primary markets.

16. This central bank intervention provided the support needed for issuers and investors to reprice risk assets, thereby allowing confidence to return and the primary markets to reopen.

17. From 18th March onwards issuance volumes picked up, starting with the highest-grade issuers (sovereigns, supranational and agencies) followed by corporates, both financial and non-financial. Strong institutional investor demand led to record volumes of new issuance, shortly before Easter.

18. As confidence returned, we saw a decline in the high new issue premia demanded by investors as the market started to reopen and in the face of persistent investor demand sizeable transactions executed with modest, and in some cases no, new issue premium.

B. Lessons to be learned from the crisis in respect of CSDR

19. Certain SMSG members voice concerns that the Covid-19 disruption is affecting the implementation of Central Securities Depositaries Regulation in time for the Feb 2021 go-live date. Resource constraints are reducing the focus required on technology development, particularly by custodians and brokers, and the readiness of SWIFT messaging enhancements to facilitate implementation for roll-out in November 2020. Moreover the legal repapering exercise

(RTS Article 25), which involves trading parties, custodians, (I)CSDs, CCPs, and trading venues (required on a global scale not limited to the EU/EEA) is largely on hold due to the current situation.

20. But more than this, the market is struggling to proceed with implementation because of structural issues that still need to be clarified by the authorities. These issues are familiar to ESMA and the Commission.

21. The SMSG recommends that ESMA works constructively with the Commission to resolve these long-standing issues as soon as possible and provide clarity to the market. The current ESMA CSDR Survey – Topics for CSDR Review" is a welcome development in this context.

V. Individual Investors – need to support increasing participation in capital markets by promoting ESO

22. Equity markets: During the current crisis, and similarly to 2008, regulated transparent equity markets showed their resilience despite periods of sharply increased volatility: trading on lit markets increased in highly volatile trading days, whereas Systematic Internalisation and OTC trading significantly decreased. EU and national policymakers should recognize the good performance of regulated markets in high-volatility circumstances and the importance of individual investors: during the global health crisis transactions in listed equity concentrated on the regulated, price forming/discovering regulated markets, and the share of individual shareholders was higher.

23. Certain SMSG members are of the opinion that more should be done to promote Employee Share Ownership (ESO). Broader long-term investment would be a significant game changer to achieve the CMU, making the EU economy more crisis-resilient and increasing the participation of citizens in the EU capital markets and in SMEs funding: if ESO reached only the level it enjoys in the US (with a much smaller population) the EU stock market cap would increase significantly and individual investment into private equity would be multiplied. The indirect effect on equity culture would be even bigger; studies show that about half of employee shareholders have then opened a stock broking account, and ESO investment is more long term than average.

    Increased Employee share ownership would, moreover, also be beneficial because of the following reasons:

    a. It would help solving the long-term liquidity/funding issues for the EU economy;
    b. Firms with ESOs perform better with regard to unemployment or salary cuts;
    c. It would help solving problems with developing equity markets in the EU (CMU goal).

VI. Corporate disclosure

A. The background: the need to strike a balance between different perspectives

24. On the one hand, the requirement for public companies to provide timely disclosure about the impact COVID-19 has had and will have on the company's financial condition and operations, is very challenging in view of the uncertainty in respect of, for example, the steps of the lock-down regimes in different states. On the other hand, especially in times of crisis, investors need as much information as possible to understand how COVID-19 is impacting the financial condition and operations of each company.

B. The risks

25. Reduced price discovery. The high level of price volatility recently observed in the markets is evidence of the huge uncertainty. Signals are difficult to interpret and each piece of news seems to have an enormous impact on prices. High volatility also puts into question the quality of the price discovery process, potentially damaging all investors.

26. Risk of race to the bottom. There is a risk of a race to the bottom, meaning that each company might consider that being the first or the only one disclosing precise negative information would hurt its own market value. For this reason, companies might tend to minimize or abstain from disclosure. If companies would actually act in this way, the final outcome would be a poor information set, damaging to investors.

C. Corporate disclosure in times of Covid-19

27. On 11 March 2020 ESMA timely recommended issuers to disclose as soon as possible relevant significant information concerning the impact of COVID-19 on their fundamentals as well as to provide transparency on the actual and potential impacts of COVID-19 in their 2019 year-end financial report or in their interim financial reporting disclosures. The SMSG fully supports this recommendation.

28. The reliability of the estimates of COVID-19 impact depends on the underlying assumptions: e.g., the expected weeks of lock-down or the expected GDP loss employed to estimate the forward-looking impact on revenues and other company figures.

29. The SMSG acknowledges that companies will face complexities and limitations on what information they can actually provide but also considers that well-functioning markets rely on good quality information, especially in times of stress. The SMSG believes that the disclosure of the expected impact of COVID-19 (as well as the assumptions employed to estimate it) is particularly meaningful. The SMSG also considers that monitoring how companies are reporting the effects of COVID-19 is useful to asess the need for further action.

VII. Re-equitizing the European economy to ensure future growth and employment

30. In the short-term, credit and liquidity enhancements will be important to support businesses that are struggling with a lack of liquidity due to the situation where the economy has been temporarily put on ice. However, while the banking system can help ensure immediate liquidity, in a longer-time perspective, equity will be needed to recapitalise the economy in order to ensure the rebuilding of a sustainable and solvent European economy. The SMSG therefore recommends that ESMA should devote sufficient resources to the implementation of the revamped Capital Markets Union plans, including the promotion of sustainable finance.

31. In the broader context of the pressing overall need for more equity capital (in both the listed and unlisted segments), Equity Markets are crucial to restore the solvency of companies, as:

    a. Listed companies can raise fresh equity capital via secondary offerings in the market.
    b. IPOs will continue to be an important source of capital for innovative growth companies, despite challenging market conditions.
    c. European and national development banks and governments will need to support equity participation to companies with a sustainable post-crisis business model that are experiencing solvency issues due to Covid-19.

    In this context, we call on ESMA to provide advice and coordination to facilitate measures aimed at post-crisis reinforcement of equity capital.

32. The post-crisis world will be built upon the choices we make now. Equity markets have a crucial role to play in this regard, financing a sustainable economy and confronting the threat posed by climate change. The SMSG is of the opinion that the proposed fund for EU IPOs should support both IPOs and secondary issuances. While contributing to relaunching IPOs, its most important function may be supporting already listed SMEs that want to tap additional funds in the market.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's web-site.

Adopted on 29 June 2020.

[signed]

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Chair
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