

Mr Jean-Paul Gauzès
President
European Financial
Reporting Advisory Group
(EFRAG)
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Ref: ESMA response to EFRAG's consultation on Equity Instruments – Research on Measurement Project

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's consultation aimed at providing input for the preparation of an advice to the European Commission on possible alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments. Whilst we have provided detailed input to the relevant questions via the online questionnaire, in this letter we wish to convey some general remarks, with the objective of ensuring that investor protection and financial stability considerations are taken into consideration when addressing measures that aim at promoting sustainable investment in Europe.

ESMA plays an active role in supporting different initiatives relating to the European Commission's Action Plan Financing Sustainable Growth and that address various areas of financial markets legislation including corporate disclosures. ESMA is convinced that transparency on financial and non-financial factors affecting issuer's performance and position is a key element to promote efficient and effective allocation of resources to long-term investments.

From this perspective, we strongly believe that, in order to best support long-term investment and contributing to the shift towards a more sustainable European and global financial system, public financial disclosures should remain focused on depicting economic reality in a neutral way, while avoiding the possibility of giving rise to structuring opportunities and incentives to short-term opportunistic behaviour.

In this respect, we note that the European Commission's request for advice focuses on alternatives accounting treatments to fair value through profit or loss for equity instruments and equity-type instruments that properly portray the performance and risks of long-term



investment business models. However, we note that in the absence of clear definitions of elements such as 'long-term business model' and 'equity-type instruments' it would be challenging to target the specific economic features which an accounting solution alternative to IFRS 9 *Financial Instruments* should depict.

In our view, in the absence of evidence to the contrary, the current provisions in IFRS 9 already cater for an adequate depiction of financial instruments, thanks to the dual reflection of: (i) the 'business model' in the context of which these instruments are managed; and (ii) their contractual cash flow characteristics. Particularly, the economic characteristics of equity instruments would generally not be adequately reflected by cost-based measurement, especially when current value information is reliable and available. This is because, in our view, even for long-term investors, updated information on the performance, risk and position of their investments – including those in equity instruments – provides useful data points for steering their investment decision-making processes. For example, updated information enables investors to take timely decisions to rebalance, where necessary, investment portfolios, including those held as part of a long-term strategy.

Furthermore, under a cost-based measurement, it is of paramount importance that there is an effective impairment model capable of providing timely information on potential losses that may affect the concerned investments. In our view, as indicated to EFRAG in our previous comment letter on the 2018 Discussion Paper *Equity instruments: Impairment and Recycling*¹, at present no such model seems to exist.

ESMA acknowledges that concerns have been expressed with respect to the reported volatility that may accompany the use of fair value measurement, especially when equity investments are held in the context of a long-term strategy. However, we note that IFRS 9 provides an option to mitigate this volatility by allowing issuers to account for the year-on-year fair value changes into the statement of Other Comprehensive Income (OCI) rather than directly in the statement of profit or loss. Nevertheless, this option has been criticised for the lack of a possibility to 'recycle' into the profit or loss statement any gain or losses accumulated over time on the equity instruments. ESMA has expressed concerns – most recently in the above-mentioned 2018 response to EFRAG – on the potential introduction of 'recycling' in IFRS 9 which, may provide an incentive to engage in opportunistic short-term profit-taking strategies. Moreover, 'recycling' would also require a sufficiently robust and sound impairment model.

In addition, as acknowledged by EFRAG in its previous advice to the European Commission on Impairment and Recycling², it is not yet possible to assess any potential effects of IFRS 9 on long-term investment decisions. Similarly, ESMA is not currently aware that the application of IFRS 9 has caused any obstacles to or provided disincentives to long-term investment decisions. Therefore, in our view, elaborating an alternative accounting model for equity and equity-type instruments, in advance of having identified evidence of any concrete issues

¹ https://www.esma.europa.eu/sites/default/files/library/esma32-61-259_esma_response_to_efrag_dp_equity_instruments_-_impairment_and_recycling.pdf

² <https://www.efrag.org/Assets/Download?assetUri=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2520Technical%2520advice%2520to%2520the%2520European%2520Commission%2520on%2520Equity%2520Instruments.pdf>



regarding long term-investment arising from the application of IFRS 9, may result in a solution that may ultimately not be effective. In the context of future work of the IASB and EFRAG on the post-implementation review of IFRS 9, ESMA stands ready to assess the evidence resulting from this exercise.

Finally, we note that the European Commission in its request refers to equity-type instruments which – in our understanding – are intended as units of investment funds, such as undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIF). We would recommend EFRAG to carefully assess the specificities of these instruments in terms of their risk and return profile and to take into account that, depending on the legislation applicable to the different types of funds, they may contain – to a variable extent – also investments in complex products, such as derivatives and other structured instruments. Therefore, if alternative accounting solutions to IFRS 9 are developed for this type of instruments, we highlight that they would require the application of a 'look-through' approach in order to properly reflect the features of the different underlying investments, thereby raising concerns on the feasibility of any such alternatives.

In line with the above-mentioned considerations, at this stage, ESMA does not support any of the alternative accounting solutions illustrated in EFRAG's background document.

In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S. Maijoor', written over the typed name.

Steven Maijoor