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Incentive Mechanisms for Advancing Long-Termism and Sustainability Along the Investment Chain

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2. Acronyms

AM – Asset Manager(s)
AO – Asset Owner(s)
BN/bn - Billion
CAGR – Compound Annual Growth Rate
CEO – Chief Executive Officer
COCO (bonds) – Contingent Convertible Bonds
ESG – Environment, Social, and Governance
GISD – Global Investors for Sustainable Development Alliance
GP – General Partner
GTFP – Global Trade Finance Program
IFC – International Finance Corporation
IRR – Internal Rate of Return
JULCD – Just U.S. Large Cap Diversified Index
LDC – Least Developed Country
MIGA – Multilateral Investment Guarantee Agency
NFC – Non-financial Company
PPP – Public Private Partnership(s)
SDG – Sustainable Development Goals
UN – United Nations
U.S./US – United States
USAID – United States Agency for International Development

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5. Executive Summary

This report identifies impediments preventing asset managers, asset owners, commercial banks, non-financial companies, and regulators from adopting long-term investment strategies (referred to as "long-termism"). After outlining challenges to long-termism, this report proposes incentives and potential recommendations for these stakeholders to embrace long-termism. There has yet to be a legal definition or widely recognized metrics that define long-termism, so for the purposes of this report, long-termism is defined by business practices and investment strategies for long-term value creation with a time horizon greater than one year that produces profits for its shareholders and measurable socio-environmental benefits aligned with the Sustainable Development Goals (SDGs) for stakeholders at large. While financial and non-financial companies have shown somewhat of an appetite and progress towards long-termism, there is still a proclivity for short-term investing in the industry. The incentive for shareholders, asset owners, and others, has historically been to maximize profit in the least amount of time. However, there are changes that each of the five aforementioned stakeholder groups can make to move the needle, however slightly, towards long-termism.

Key Findings:

- Asset owners must leverage their power to incentivize other actors towards long-termism. They should consider adopting new contract terms, fee structures, and performance benchmarks that reward long-term investing and responsible business practices.
- Asset managers implementing environmental, social, and governance sensitive investment strategies create short-and long-term shareholder value. The implication is that fiduciary responsibilities as well as compensation schemes, can be re-aligned to incentivize long-term value creation.
- Banks' ability to invest long-term is highly constrained by maturity mismatch problems, liquidity risk, interest risk, and regulations. Key to balancing stability and access to finance is the use of targeted policies for qualified infrastructure and sustainable investment.
- Non-financial companies should increase information disclosure regarding their progress on implementing policies that create long-term value with social and environmental impact. It might be necessary that the incentive structures separate companies' responsibility to manage risk, from their aim to maximize return for overlapping timelines, ranging from short-term risk/return to long-term risk/return.
  In addition, NFCs should carefully consider the composition of their boards to harness board members' support in crafting business strategies that embrace long-termism.
- Regulators should consider using various non-legal measures to incentivize financial actors to invest in long-termism. Such measures include but are not limited to setting guidelines to promote the convergence of financial and non-financial reporting standards, implementing a "Comply or Explain" policy to encourage information disclosures on sustainability, and coordinating with regulatory bodies in other jurisdictions to create and adopt consistent reporting standards and terminology as well as a single, digitized regulatory access point.

6. For Least Developed Countries', credit or risk guarantee mechanisms can significantly reduce the uncertainty of investment returns and attract commercial investment in LDCs. The guarantee can be sourced from the local government, strong advanced economies, and international organizations. Other risk mitigating tools can be pooled investment

vehicles that manage risks within a diversified portfolio and achieve greater mobilization to scale up investments, such as contingent convertible bonds (i.e., COCO bonds).

7. Introduction

Illustration Credit: World Press

6.1 Defining Long-termism

Business leaders, government, and academia have, with some success, quantified the impact of short-termism on companies as well as assessed the cumulative negative impact it has had on nations' economies. And while there is no adoption of standard metrics and norms benchmarking the value added from sustainable investing in the long-term yet, this paper defines Long-termism akin to the value investment strategies producing both competitive returns and social benefits, aligned with the Sustainable Development Goals (SDGs). However, both financial gains and social benefits may not always align. In that instance, asset owners' and by extension asset managers' have to manage this misalignment based on their short-term tolerance to forgo immediate financial returns to achieve social benefits.

This study defines "long-termism" to include two conditions:

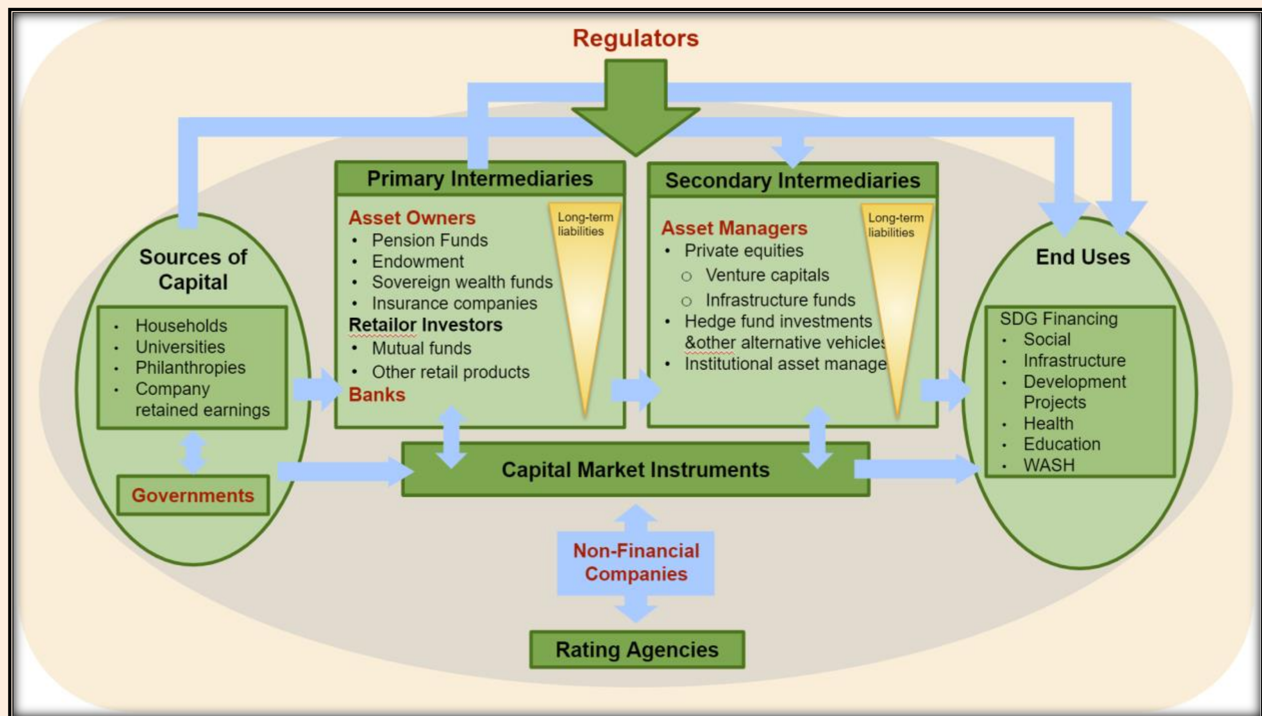
1. Investment aims, which have a positive impact on society that is measurable using socio-environmental outcomes aligned with SDG indicators.

2. An investment decision time horizon defined by a year or more: Long-term investments are defined by a maturity of a year or more; however, social impact is rarely achieved in

just a year. Conceptually, the investment horizon should match the time horizon necessary to achieve a generally accepted standard threshold measure of impact aligned with the SDGs (e.g., SDG-Tracker.org) targeted by the investment. For example, if an investment was to be aligned with “Development assistance for infrastructure” (the SDG indicator 9.A.1), the investment time horizon identified might be 5 years. Indeed, infrastructure projects are usually financed, and their value evaluated by asset owners and asset managers over a period of about 5 years. Therefore, we recommend that practitioners and regulators further this reflection and outline a clear framework defining the time horizon of Long-termism.

6.2 Financial system and actors

Figure 1: Financial System and Actors



Source: UN System Task Team (UNTT), 2013. The Working Group on Financing for sustainable development, Chapter 3: Challenges in raising private sector resources for financing sustainable development

6.3 Relative Performance Metrics to Measure Long-termism

It is crucial that the global financial community uses metrics in order to measure long-term impact. It is suggested that asset managers and banks use both relative and absolute performance metrics. Below are some suggested metrics to quantify long-termism.

6.3.1 Compound Annual Growth Rate (CAGR)

This metric looks at the average annual rate of return per year for an asset. The longer a stock has been posting gains means you get a better look at the health of a company. What this metric does is give you an estimate of how much your investment may return each year.

6.3.2 Price to Book Ratio (P/B ratio)

The price to book ratio measures whether a stock is over or undervalued by comparing the net value (assets — liabilities) of a company to its market capitalization.

6.3.3 Cash Flow

If the amount of free cash flow is increasing year over year, this should hopefully lead to an increase in the share price and an increase in dividend payments.

6.3.4 Internal Rate of Return (IRR)

The Internal Rate of Return (IRR), which considers multiple cash flows and periods. This reflects the fact that cash inflows and outflows often constantly occur when it comes to investments.

6.4 Using ESG Investments as a Proxy for SDG Investing

Due to the higher prevalence of ESG (Environment, Social and Governance) investments, this study considers ESG investments as a proxy for the investments that are aligned with and contribute to the SDG goals. Sustainable investments or ESG rated investments are breaking records both in inflows of money from investors as well as having higher profitability than its conventional peers despite the current global crisis. According to John Hale from Morningside[1], investors moved 10.5 billion USD into 314 open-end and exchange-traded sustainable U.S.-based funds in the first quarter - a new record after 2019's fourth quarter shift of nearly 8 billion USD. BlackRock's 16 iShares ESG exchange-traded funds commanded 6.3 billion of the totals, followed by Vanguard, Calvert, Dimensional and TIAA/Nuveen.[2] Similarly, since the start of last year, the 100 percent sustainable portfolio of UBS's private banking unit in Asia more than doubled to 1 billion in assets.[3] UBS reported about 60 percent of investments come from Greater China and that demand has heightened since the COVID-19 outbreak.

From a profitability standpoint, sustainable investments continue to show good performances relative to traditional investments pre and post COVID-19. For instance, on its third quarter evaluation of 2020, Morningstar found that, for the year to date (from October 30), 25 of 26 ESG-focused index funds outperformed their conventional index-fund counterparts. Meanwhile, Just Capital's large cap diversified index, JULCD[4], which tracks the companies most dedicated to their stakeholders and environmental impacts, outperformed the broader Russell 1000 by 100 basis points since the market's peak on February 21. On a similar note, earlier in 2020 Bloomberg[5] revealed that in the current volatility, the average ESG fund declined 12.2 percent in 2020, almost half the decline of the S&P 500 and, also, that older ESG funds have been outperforming newer ESG funds in the current volatility. Likewise, Bank of America, on its 2019 publication titled *"ESG from A to Z: a global primer"*[6] reported that among U.S. companies on the S&P 500 index, those that scored in the top fifth of ESG rankings outperformed their counterparts in the bottom fifth by at least three percentage points every year for the past five years, proving not only that unconventional impact-oriented portfolios embrace sustainability but it also debunks the myth that ESG strategies limit profitability.

[1] https://www.morningstar.com/articles/977328/despite-the-downturn-us-sustainable-funds-notch-a-record-quarter-for-flows

[2] https://www.morningstar.com/articles/977328/despite-the-downturn-us-sustainable-funds-notch-a-record-quarter-for-flows

[3] https://www.bloomberg.com/amp/news/articles/2020-04-02/virus-boosts-rich-asian-interest-in-sustainable-investing-trend

[4] https://justcapital.com/news/companies-most-dedicated-to-their-stakeholders-have-outperformed-the-market-during-the-coronavirus-crisis/

[5] https://www.bloomberg.com/news/articles/2020-03-13/older-esg-funds-outperform-their-newer-rivals-in-market-tumult?sref=wINQCNXe

[6] https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID19_12722/ESG_from_A_to_Z.pdf

To make an even stronger case for this paradigm shift on investments, the longest-standing firms in the field of ESG are reaffirming and increasing their commitments; Barclays is launching a new ESG Fundamental research unit to explore how the COVID economic crisis is creating a greater sense of urgency and responsibility towards everything that has to do with consumer behavior, disruption of value chains, the future of work, mobility and climate change. Morgan Stanley has created an institute for sustainable investing, working with academic institutions and clients to help mobilize capital to sustainable enterprises, via global markets and the production of documents[7] for institutional investors.

"The pandemic has made very clear the complexity and interconnection of our world in terms of supply and demand in trade, and how everything can be absolutely threatened if not managed under a sustainable strategy" says Nigel Green leader of the DeVere Group that has 12 billion of assets under management. Further, earlier this year, Larry Fink, CEO of Blackrock, published an open letter[8] to its customers, which can be interpreted as a call to the industry to shift and improve their ESG standards. This call highlights the risk of climate change as the main threat to humanity, and how this new reality can potentially forever alter the nature of investment processes as we move forward. New generations are understanding the risks of short-term, profit-seeking, careless behavior on investments, for which it is crucial to find middle ground integrating sustainability and positive returns. Time is of the essence, which is why the financial industry needs to challenge investment groups into being the drivers of change and to use investments as a vehicle for collective transformation.

8. Research Objectives

This report is a follow up to an earlier SIPA Capstone project which reviewed the obstacles impeding institutional investors from making long-term investments in sustainable development aligned with the Sustainable Development Goals (SDGs). This report aims to identify and advance concrete actions incentivizing non-financial companies, commercial banks, asset managers, asset owners and regulators to reconsider short-term investments to embrace "Long-Termism", identified as contributing value creation aligned with the SDGs.

9. Methodology

The methodology involves a combination of desk research and consultations with representatives of the consistencies listed above (i.e., non-financial companies, commercial banks, asset managers, asset owners and regulators) to collect data and empirical evidence on factors and best practices fostering "Long-Termism". Publicly available academic papers, empirical evidence, interviews of academics and financial industry participants is analyzed to map the incentive and risk management strategies enabling companies and key financial sector actors to embrace long-termism.

[7] Last report on performance of sustainability finds can be seen here: https://www.morganstanley.com/content/dam/msdotcom/en/assets/pdfs/3190436-20-09-15_Sustainable-Reality-2020-update_Final-Revised.pdf

[8] https://www.blackrock.com/corporate/investor-relations/blackrock-client-letter

10. Asset Owners

Illustration Credit: World Press

9.1 Introduction

Asset owners' commitment to invest material sums towards sustainable practices with long-term objectives can result in a multiplier effect to the whole financial system. There is no prominent statistical evidence that investors are foregoing returns when embracing an impact investing strategy. Existing literature and studies suggest that it is feasible for institutional asset owners to meet their financial goals and support enhanced fiduciary duties from their asset managers through long-termism in order to have a positive impact in achieving the SDGs. Asset owners are central actors of the financial and investment ecosystem and can choose to invest in companies embracing sustainability practices and leverage demand that their asset managers do the same.

9.2 Current Environment

In 2019, Asset owners (pension funds, sovereign wealth funds, insurance companies, etc.) increased total assets under their management by 15 percent, to $89 trillion (Boston Consulting Estimate) and McKinsey & Company estimates that three quarters of the total financial assets are managed directly by the asset owners themselves (Blackrock, 2018). Asset owners can leverage their portfolios to move to long-term sustainable investing. They can request information on

sustainability measures from companies they invest in, and use their influence to sanction non-complying actors.

Asset owners have singular investment objectives and constraints. A number of pension funds, endowments and other asset owners have made steps towards committing to long-termism. Moving funds towards sustainable investments can generate measurable positive social and environmental impact, however, asset owners and fund managers' principal objectives remain to produce the highest possible returns with the lowest possible risks. Using a materiality framework creating a link between financial materiality and long-term progress towards the SDGs is essential. The existing literature and studies suggest that it is feasible for institutional asset owners through long-termism to achieve both high returns and impact towards achieving the SDGs and require enhanced fiduciary duties from their asset managers.

9.3 Challenges and Incentives

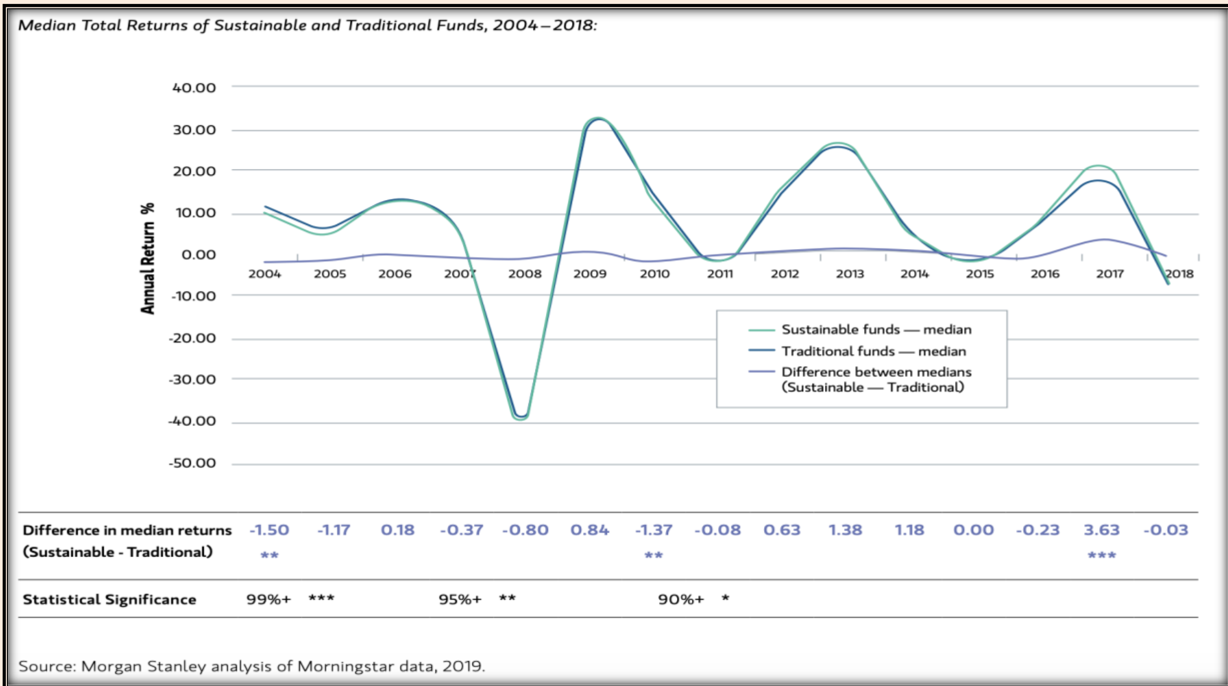
There are different factors that undermine the quick adoption of sustainable investment practices by asset owners. One of them is the perception that ESG or other sustainable investments yield inferior financial returns. The data proves otherwise, but the persisting misconception suggests the necessity to raise asset owners' awareness that short-termism does not yield superior long-term returns. We see asset owners and the GISD, who are committed to support long-termism and achieve the SDGs, having an impact while echoing their support through public advocacy initiatives modeled after existing successful campaigns such as: Climate Action 100+, "A five-year initiative led by investors to engage systemically important greenhouse gas emitters and other companies across the global economy that have significant opportunities to drive the clean energy transition and achieve the goals of the Paris Agreement." To that aim, the concept and term: "long-termism" needs to be clearly defined by asset owners.

A study surveying 2,200 individuals in the U.S, Europe, Japan, and Australia, established that over the last few decades there has been a correlation between ESG practices and financial performance in developed markets. Nearly 90 percent of the studies came to the conclusion that there is no negative correlation between corporate financial performance and ESG practices, with the majority of the studies suggesting a positive correlation between performance and sustainable investment practices (Barnett & Salomo, 2006; Bauer et al, 2006; Bello, 2005; Cortez et al, 2011; Durán-Santomil et al, 2019; Friede et al, 2015).

A Morningstar study (an American financial services firm), also highlights that there is no statistically significant evidence that investors sacrifice returns when embracing ESG practices (n.d.). The analysis by Morgan Stanley of Morningstar's data between 2014 and 2018 showed that sustainable funds' returns do not underperform when compared to conventional ones (as illustrated in Figure 2).9

[9] Morgan Stanley Sustainable Reality Report Reveals Sustainable Funds Outperformed Traditional Funds and Reduced Investment Risk Despite Global Pandemic. (2020, September 17). Available at https://www.morganstanley.com/press-releases/morgan-stanley-sustainable-reality-report-reveals-sustainable-fu/

Figure 2: Median Totla Returns of Sustainable and Traditional Funds (2004-2018)



Source: Morgan Stanley analysis of Morningstar data, 2019

In 2020, sustainable funds inflows in the U.S. reached $30.7 billion. According to a 2020 Nuveen report, 53 percent of the investors cited the superior financial performance of sustainable equity funds as the primary motivation for investments. Indeed, according to Morningstar, in the third quarter of 2020, 12 sustainable index funds with an average return of 9.4% outperformed conventional iShares. Core S&P 500 ETF funds with returns of 8.9 percent (*as can be seen in Figure 3*).[10] This year's outlook confirms the trend. Notably both funds targeted the same market segment.

[10] Hale, J. (2020, October 30). Sustainability Matters: Sustainable Equity Funds Turn In Another Strong Quarter. 2020, from https://www.morningstar.com/articles/1007824/sustainability-matters-sustainable-equity-funds-turn-in-another-strong-quarter

Figure 3: U.S. Sustainable Equity Index Fund

U.S. Sustainable Equity Index Funds

		Q3 2020		YTD					Selection Effect		
	Ticker	Total Return	% Rank Category	Total Return	% Rank Category	Sustainability Rating	Energy %	Technology %	Energy	Technology	Stock
IQ Candriam ESG US Equity ETF	IQSU	10.94	7	14.88	2	5 globes	0.59	36.19	0.58	0.24	0.92
Calvert US Large Cap Core Rspnb Idx I	CISIX	10.64	8	10.97	6	4 globes	0.08	31.54	0.78	0.10	0.66
Vanguard FTSE Social Index I	VFTNX	10.59	8	9.20	8	4 globes	0.00	32.76	0.81	0.14	0.65
iShares MSCI USA ESG Select ETF	SUSA	10.35	10	10.91	6	5 globes	1.31	30.70	0.28	0.09	1.16
Vanguard ESG US Stock ETF	ESGV	10.11	12	10.37	6	4 globes	0.01	31.38	0.81	0.10	0.32
iShares ESG Aware MSCI USA ETF	ESGU	9.41	24	8.18	11	4 globes	1.91	28.97	0.00	0.05	1.33
Xtrackers S&P 500 ESG ETF	SNPE	9.19	29	7.66	13	4 globes	1.95	30.00	0.03	0.04	0.22
Nuveen ESG Large-Cap ETF	NULC	8.77	44	7.29	14	5 globes	1.44	28.51	0.19	-0.12	-0.23
iShares MSCI KLD 400 Social ETF	DSI	8.77	44	7.82	12	5 globes	1.24	32.58	0.29	0.13	-0.66
Xtrackers MSCI USA ESG Leaders Eq ETF	USSG	8.12	56	5.68	27	5 globes	1.67	27.62	0.13	-0.03	-0.98
iShares ESG MSCI USA Leaders ETF	SUSL	8.12	57	6.13	23	5 globes	1.66	27.59	0.13	-0.03	-0.99
Fidelity® U.S. Sustainability Index	FITLX	8.09	57	6.06	24	5 globes	1.94	27.84	0.13	-0.01	-0.96
U.S. Large Cap ESG Index Funds (n=12)		**9.43**	**30**	**8.76**	**13**	5 globes	**1.15**	**30.47**	**0.35**	**0.06**	**0.12**
iShares Core S&P 500 ETF	**IVV**	**8.92**	**37**	**5.56**	**29**	3 globes	**1.99**	**28.13**			

Source: Morningstar Direct. Data as of 9/30/2020. Note: Oldest shareclass used for mutual funds.

Source: Morningstar Direct, data as of 9/30/2020

In sum, the socially responsible investments, particularly within the large-cap space, can and at large do contribute to some positive social cause while having similar risk-adjusted returns as their conventional counterparts (Dolvin et al., 2017). Based on studies by Nuveen, 85 percent of investors are willing to divert their funds to sustainable investments in such scenarios. Hence, highlighting the opportunity to align values to investments to produce positive impact can increase inflows towards sustainability focused investments. In the US, according to Nuveen's 2020 report, over 82 percent of 1,007 investors surveyed, over the age of 21, with $100,000 in investable assets, believe that consumers and investors decisions can have an impact.

9.4 Recommendations

Asset owners are central actors of the financial and investment ecosystem and have a capacity and mechanism not only to allocate their resources to projects aligned with sustainability practices, but to also encourage asset managers to follow the same path. Already in 2013, a McKinsey and the Canada Pension Plan Investment Board (CPPIB) survey, polling over 1,000 board members and C-suite executives around the world highlighted a mismatch between understanding the need for long-term investments and the actual allocation, due to increasing pressures from the boards, investors, and institutional shareholders to achieve short-term returns. This is a consistent trend among industry actors, that highlights the different time horizons, incentives, and goals for asset owners and asset managers (Focusing Capital on the Long Term, 2014).

The contractual terms and fiduciary responsibilities of asset managers must better reflect and be aligned with the asset owners and investors' long-term interests and objectives, particularly for pension and endowment funds. Asset owners' long-term interests should drive investment strategies and be tracked using key performance indicators (KPIs) tied to evaluate the performance and compensation of asset managers.

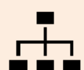
FCLTGlobal, a non-profit organization that develops research tools facilitating long-term investing and business decisions, has identified ten conditions for asset owners and asset managers to steward long-termism (FCLTGlobal, 2018). The list includes development of contract terms and fee structures rewarding a long-term focus, adoption of appropriate benchmarks and performance reporting (which could be used by either side, though the focus remains on asset owners). Following is the list of these conditions, adjusted to foster long-termism (Leatherman et al., 2019).

1. **Changing fee structures -** The fee structures would focus on long-term performance. Adoption of discounts based on longevity of the relationship between asset owners and asset managers.

2. **Rethink benchmarks -** Negotiating the use of benchmarking over an appropriate time frame.

3. **Contract term -** Asset owners would set contracts spanning several years to encourage asset managers to focus on long-term performance and the interests of asset owners. Note that asset owners would retain their privileges to terminate contracts as per pre-agreed conditions.

4. **Redemptions** - Negotiating in-kind redemption provisions as part of the manager's compensation.



5. **Manager/Strategy Capacity** - Clarifying the terms and boundaries of an investment strategy's capacity.

6. **Performance reporting** - Refocus reporting of returns from short-term results alone to long-term objectives.

7. **Projections** - Defining an acceptable tolerance for risks relative to returns for different investment time-horizons that would alleviate pressures exerted by the short-term risks.

8. **Disclosures** - Disclosing expectations on asset managers' investment and business conduct beyond performance could help keep the operations aligned with the principles of long-termism.

9. **Evaluation process** - Setting clear ex-ante expectations to evaluate an asset manager, facilitated by regular performance review meetings to discuss robust long-term returns.

10. **Active ownership -** Engagement with the investee companies would be part of the mandate to help asset owners ensure that companies operations are aligned with the SDGs. Asset owners can also leverage their economic ownership and voting rights, using strategic voting procedures to defend their long-term interests.

Below are a few empirical examples illustrating how asset owners have influenced investees towards strategies and practices consistent with long-termism:

- In 2019, the Church Investors Group, (21bn GBP) informed leaders of FTSE 350 companies that they would take a tougher voting line in scenarios where reform on key issues that they prioritized were too slow to materialize. Using a common voting template, they held their managing directors accountable and voted against their re-election when ES impact metrics were not met (CIG, 2019). Tying voting rights to factors linked to long-termism could be very effective.
- Since becoming a signatory to the United Nations-supported Principles for Responsible Investment (PRI) in 2008, Blackrock has been actively engaged with its investee companies. In 2017, they had over 1,500 such engagements with notable work being done in the energy and pharmaceutical sectors in response to climate change concerns and the U.S. opioid epidemic. Blackrock's Investment stewardship and investee engagement to promote corporate governance practices that are consistent with long-term value creation, provides a template for shareholders to exercise their voting rights in alignment with long-termism (Rosenblum et al., 2018).

10. Asset Managers

Illustration Credit: World Press

10.1 Introduction

Socially responsible investing (SRI) emerged in the 1970s in thanks due to faith-based organizations wishing to align their investment with their values, believing that their activism as investors could influence companies' practices. SRI, then, was largely viewed as a marginal investment approach. While some asset managers have been in the responsible investing space for many years, others are relatively new to the field. This section aims to make the business case for long-termism to asset managers reluctant to commit to sustainable investing.

10.2 Current Environment

The evaluation of asset managers can be divided into two segments: Financial performance and non-performance factors (i.e., the investment process and sustainable investing practices).

10.2.1 Financial Performance

Financial performance of asset managers is usually evaluated based on objective criteria, often on a relative basis against a benchmark. For most asset managers, these objective criteria include but are not limited to, some measure of risk-adjusted returns and volatility. For most index funds, their performance evaluation is almost predominantly based on their expense ratio while other factors such as tracking errors may also be considered. Regarding the selection of benchmarks, when broad-based portfolios were the norm, peer group benchmarks were commonly used to measure performance (Bank of International Settlements, 2003). However, this practice has declined substantially in the past decades because the benchmarks were found to have led managers into mimicking each other's asset allocation. As a result, today, market indices benchmarks are more frequently used to assess fund performance. However, this practice also has shortcomings partly because the consistent use of a small range of core market indices also encourage convergence in behaviors.

10.2.2 Non-performance Factors

Institutional investors such as pension funds have increased their reliance on outside consultants to evaluate non-performance factors. The consultants complete the due diligence of soft investment factors (i.e., factors which relate to the investment process) and service factors (i.e., factors which relate to service delivery) that are identified to produce superior long-term performance. Amongst the common criteria assessed are idea generation and portfolio construction. Business factors such as staff's qualification, experience and their compensation schemes are reviewed as well. Similarly, the assessment of sustainable investment portfolios is frequently outsourced to consultants. Principles for Responsible Investments (PRI) cites the most common assessment methods to be market screening, request for information, questionnaires, and in-person meetings (Principles for Responsible Investment, 2016).

Worth noting, the assessment of these non-performance factors can be highly qualitative and individualized. Part of the reason is that the scope of the advice sought from investment consultants depends on the professional skills of the trustees as well as the complexity of the investment strategy they follow. Assessing non-performance factors in the context of long-

termism raises the question of the materiality of factors such as: the uncertainty around the likelihood of new regulations, the assessment of the data inconsistent with long-term social impact and the absence of recognized metrics defining long-termism and their reporting framework (Jenkinson et al., 2016).

10.2.3 Performance-related Compensation Schemes

The compensation schemes for asset managers usually involve fees as a fixed percentage of assets under management (AUM). Such schemes reward the relative performance of asset managers in an indirect manner. Even when fees are not directly tied to performance, the nexus between performance and fund inflows may act as an implicit incentive structure. Yet it should be noted that managers under this implicit incentive arrangement are more likely prone to herd behavior because of the weakened strength of incentive for outperformance. Hence, the scheme may lead managers to increase portfolio turnover and disincentivize them from holding contrarian positions, especially during crisis periods. On the other hand, explicitly performance-based incentive schemes are usually used in hedge funds and other alternative investment vehicles. One of the major benefits of such schemes is the increased strength of incentive for outperformance which discourages managers from mimicking each other's asset allocation. However, they may produce other adverse incentive effects that lead to gambling-like behaviors because of the option-like payoff structure of such arrangements. As a result, the use of performance-based fees may also have the shortcoming of promoting “short-termism.”

10.3 Challenges and Incentives

Asset managers are challenged by several disincentives to embrace “long-termism”:

- Asset allocation was largely influenced by the size of their institutional investor funding flows. Early studies highlighted that past performance was a leading factor directing investors’ flows; investors focused on past performance as a signal of manager quality or ability. However, recent evidence suggests that institutional investors’ premium for past performance may be imputed to agency problems existing within their organizations, i.e., their fiduciaries value managers’ prior return performances because those are easily observable and justifiable to upper management and trustee committees. Jones and Martinez (2017) report that institutional investors are more likely to allocate funds to managers whom they think will do well in the future as opposed to those who did well in the past. The undue weight on recent past performance exerts significant pressure on asset managers to embrace short investment horizons.
- Some mutual funds and index funds are also reluctant to practice sustainable investing because the costs considered outweigh the private benefits they receive. It is crucial to acknowledge that for asset managers, engaging in sustainable investing is desirable if the marginal personal gains exceed the marginal personal cost. Possible misalignment of investors’ ownership and managers’ control, implies that managers might not receive the full benefits of sustainable investing while bearing their entire costs. As a result, when the managers’ personal benefits are not material, they are reluctant to pay a premium for assets issued by companies with positive sustainable records achieved long-term. Since

fund managers are generally compensated by management fees as a fixed percentage of AUM, there is a positive relationship between asset managers' engagement in sustainable investing and the size of sustainable investment assets under management. Yet, a recent report by Lucian Bebchuk and Scott Hirst suggests that the current compensation incentive system discourages managers to allocate funds towards sustainable investment funds (2018).

- Managers also become disincentivized to engage in "Long-termism" when they can improve their short-term financial performance through "momentum investing" in order to enhance their funds' overall returns.

- Managers can also appeal to investors by reducing their operational expenses or seeking socially-minded investors interested in companies embracing ESG integration and Corporate Stewardship. Most managers' compensation is based on their AUM, therefore they are encouraged to concentrate on immediate high-payoff strategies generating fund inflows (e.g. cost-cutting) at the expense of strategies controlling risks in the long-run (such as ESG integration). Worse yet, it may create a perverse incentive for managers to "green wash" their portfolios because the cost of advertising ESG efforts certainly pales in comparison to the cost of the actual commitment. Moreover, the subjective and qualitative nature of ESG assessment may also amplify this perverse incentive because it is difficult for investors to closely track the ESG efforts made by the managers.

10.4 Recommendations

Most of the challenges identified for asset managers result from the fact that investors or stakeholders of asset owners, on average, do not value activities associated with "long-termism" (e.g., having long investment horizons, practicing sustainable investing, etc.) to the same degree as other immediate high-payoff activities (e.g., short-term gambling, cost-cutting, etc.). The current compensation structure of asset managers is biased towards investors' demand for higher short-term returns, and creates a perverse incentive for managers to allocate funds to create long-term value. Investor's prerogative for (on-demand) redemptions requiring liquidities likely invested in short dated instruments further exacerbate this bias in favor of short-term strategies.

Secondly, Incentive schemes designed to foster "long-termism" need to offset current incentives embedded in the high payoff of short-term strategies. Recent data suggest openness to a shift in favor of longer-term strategies. A February 2020 McKinsey study concluded that investment professionals' perception over the past decade has shifted (Delevingne et al., 2020). Their research confirms that environmental, social and governance sensitive investment strategies create short-and long-term shareholder value. As 83 percent of C-suite leaders and investment professionals expect that ESG initiatives will add more shareholder value in five years than today. Furthermore, respondents indicated that they are willing to pay a medium premium of about 10 percent to acquire a company with a positive ESG record. These findings suggest that compensation schemes adjustments, capturing a portfolio value creation over a five to seven-year period, would be aligned with investment professionals' return expectations. Yet today, education aimed at asset managers reluctant to invest in assets generating

long-term value, “long-termism”, seems necessary to increase the velocity of such assets under management. While asset managers could consider lock-in periods to anchor investors’ flows into sustainable long-term value funds, the approach will be resisted by many investors. More importantly, it may not be necessary because there is a business case in favor of long-termism. It is important to bear in mind that investment strategies aligned with “long-termism” achieve better, risk-adjusted returns. Long-term value investment strategies are aligned with investors’ demand for strategies reducing their exposure to climate change-related risks; and the necessity to fund a net-zero economy fostering the profitable resilient companies of tomorrow.

- Provision for liquidity needs and redemptions to build portfolios aiming to create both long-term value (long-termism) and higher returns.

- Invest today in long-term value investment strategies are expected to yield better returns five to seven years from now than those made in companies or assets exposed to climate risk that will be unprofitable by then.

- Additional research be made to explore agency problems existing between investors and managers that constrain the adoption of long-termism.

11. Commercial Banks

Illustration Credit: World Press

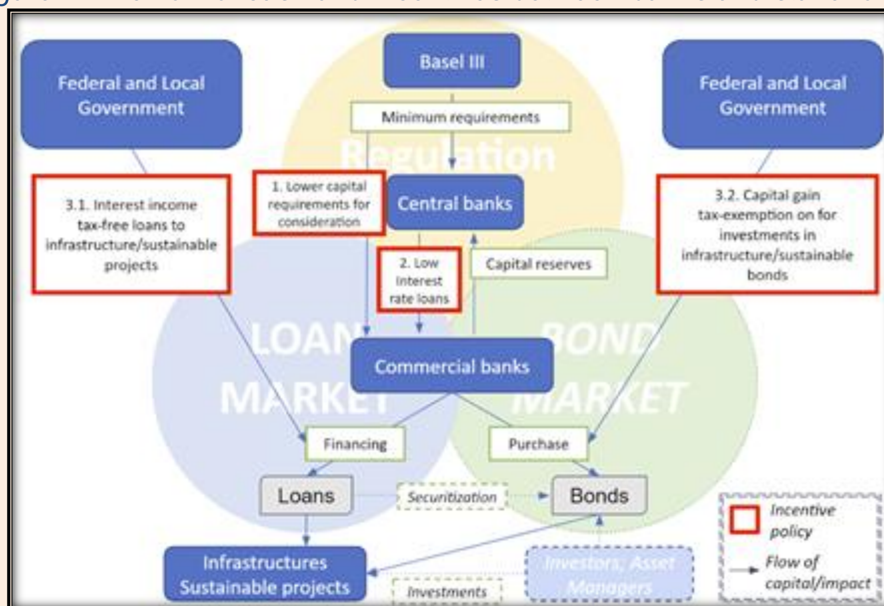
11.1 Introduction

Commercial banks play an important role in infrastructure finance in emerging markets. In many countries, bank loans are essential to finance long-term investments, especially in infrastructure in emerging markets where bond markets and other asset managers are relatively

underdeveloped and unable to meet the required level of infrastructure finance (UN DESA; OECD; MAS, n.d.). However, after the global financial crisis, banks' ability to lend long on their short-term assets are further constrained. Moreover, the finance gap for infrastructural investment to meet SDG goals is still outstanding. In many emerging economies and European countries, banks are the major providers of long-term lending to infrastructure projects. To be profitable, banks need to manage maturity mismatch, liquidity risk, and interest risk. Banks' return on assets (ROA) are historically low, hence the need for the securitization of assets and by extension the need to increase the securitization of sustainable and infrastructure loans to meet the investment needs. Further, banking regulations tightened after the 2008 global financial crisis have increased banks' funding costs and reduced maturities of loans issued. To balance stability and access to finance, targeted policies for qualified infrastructure and sustainable investment are needed such as targeted capital requirements and possibly the use of an additional base interest rate, used exclusively to support long-termism. Fiscal tools could also be used by the federal and local government to incentivize funding and investment in sustainable or infrastructure loans and notably, the main obstacle of these incentives is the absence of coordinated, generally accepted, common global taxonomy of long-term investments

This part of the report will briefly describe the current environment and challenges banks face and discuss potential incentive policies to simulate long-term bank lending to infrastructure and sustainable investment. Figure 4 illustrates how commercial banks function and interact with other stakeholders to finance long-term projects and how they are regulated/incentivized by authorities.

Figure 4: The flow of cash and incentives between banks and stakeholders



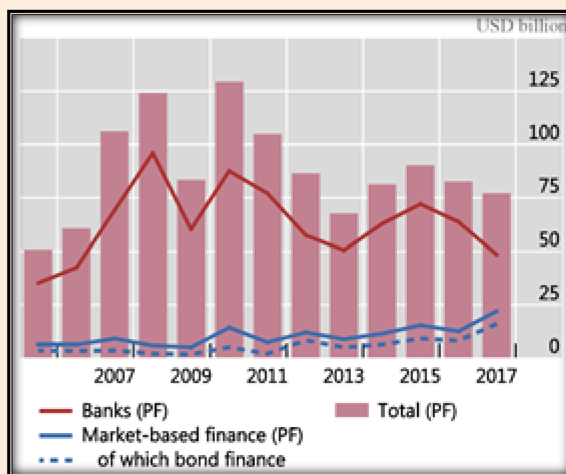
Source: the authors of this report

11.2 Current Environment

11.2.1 Infrastructure loans issue decreased - infrastructure gap increased

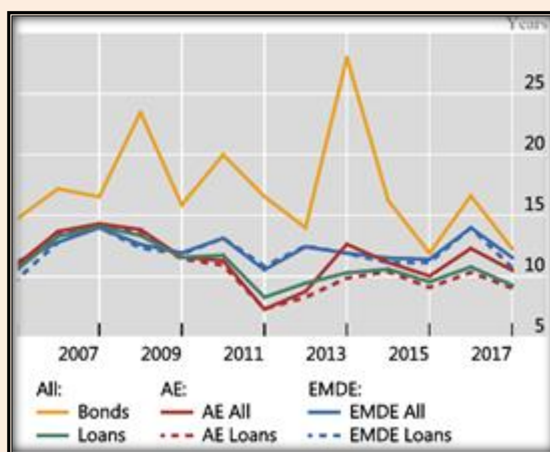
Remaining the dominant infrastructure finance provider after the global financial crisis, bank loan growth has slowed while bond financing and non-bank lending have picked up in recent years Figure 5. In addition, the maturity of bank loans in advanced economies have decreased by three years since 2009 (see Figure 6 below) (Financial Stability Board, 2018).

Figure 5: Infrastructure Finance Volume by Different Providers



Source: Financial Stability Board, 2018.

Figure 6: Maturity by Instrument and Economies



Source: Financial Stability Board, 2018.

Regardless of type, infrastructure development has strong positive externalities for the aggregated economy and social well-being and is crucial for shifting to a sustainable economy (Bassanini & Reviglio, 2011). However, the global economy is facing substantial financing gaps

in infrastructure investment, in multiples of trillions of USD per year (The Global Infrastructure Hub, 2017; B20 Infrastructure & Investment Taskforce, 2014).

Estimations from many organizations show that from 2016 to 2030, global infrastructure investment needs will range from $54 trillion to $104 trillion and financing gaps from $11 trillion to $20 trillion, depending on the investment goals to be achieved. Below are some specifics of estimation from various sources:

- *The Global Commission on the Economy and Climate estimated the funding demand for sustainable infrastructure investment to be around $90 trillion, driven by the aging infrastructure in developed countries and rapid urbanization in developing countries* (The Global Commission on the Economy and Climate, 2016).

  G20's The Global Infrastructure Hub considers meeting the SDGs for universal access to electricity and water, and sanitation in all low- and middle-income countries. If current investment trends continue, the forecast value of investment need is $54 trillion, and the gap is $11 trillion, to meet the infrastructure investment needs for seven sectors across 50 countries and the previous SDGs by 2030 (The Global Infrastructure Hub, 2017).

- *McKinsey & Co suggests that to keep pace with projected GDP growth and meet SDG goals, the world needs to invest an average of $4.7 trillion every year in roads, railways, ports, airports, power, water, and telecoms, totaling $70 billion from 2016 to 2030* (Woetzel, Garemo, Mischke, Kamra, & Palter, 2017).
- *B20 Infrastructure & Investment Taskforce estimates that around $60–70 trillion additional infrastructure capacity will be needed globally, and a gap of $15-20 trillion from 2015 to 2030* (B20 Infrastructure & Investment Taskforce, 2014).
- *OECD estimates that $ 95 trillion of investments are needed in energy, transport, water, and telecom infrastructure, equating to $ 6.3 trillion per year. Another $ 9 trillion is needed for this infrastructure to be consistent with a Sustainable Development scenario, equating to $ 0.6 trillion per year (Mirabile, Marchal, & Baron, 2017).*

11.3 Challenges and Incentives

11.3.1 Maturity intermediation and loan securitization

Infrastructure projects are funded by long-term loans booked on the commercial banks' asset side of their balance sheet, while commercial banks' balance sheet liability side includes demand term deposits. Thereby, the funding of longer-term projects added banks' exposure to risks, including maturity mismatch, liquidity risk, and interest risk. Meanwhile, banks' return is historically low; notably, US commercial banks' ROA has fallen below one percent (see Figure 7) (FRED, 2020).

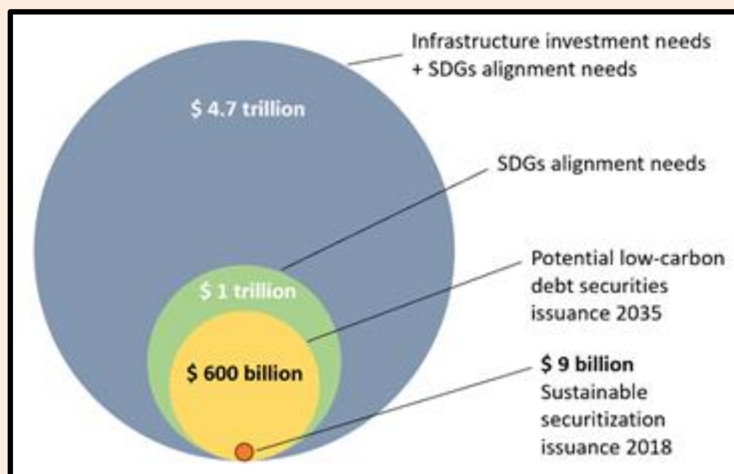
Figure 7: Return on Average Assets for all U.S. Banks

Source: St. Louis Federal Reserve

A massive and liquid securitization market of bank loans can transfer banks' risk to investors and scale up infrastructure and sustainable financing to the level required by SDGs. Although the sustainable securitization market has proliferated in the past few years, it is still small relative to the necessary volume of infrastructure projects and sustainable investments.

In 2018, the amount of sustainable securitization issued was $8.7 billion, which dropped significantly (by 69 percent) from the 2017 peak (SEB; White & Case; S&P Global Ratings; G20 SFSG, 2018). OECD projected that global issuance of green debt securities could grow to more than $600 billion in 2035. Even if the projection can be realized, the volume of sustainable securitization is still low compared to the trillions of dollar investments needed to meet SDG goals (see Figure 8).

Figure 8: Finance Gap for Infrastructure and Sustainable Investments



Source: McKinsey & Co, 2017. Skandinaviska Enskilda Banken (SEB), White & Case, S&P Global Ratings, 2018.

11.3.2 Banking regulations

After the global financial crisis, banking regulations have been tightened to address deficiencies and improve risk management. The Basel Accords are one of the most influential international regulatory frameworks in the banking sector. The 2009 Basel III reforms increased capital and liquidity requirements for banks. One of the intended effects of the reform is “to reduce overreliance on short-term funding for maturity transformation purposes,” but meanwhile, they imposed unintended negative impact on long-term lending, which includes infrastructure finance and project lending (Financial Stability Board, 2018).

Several regulations or standards are identified as potentially relevant to infrastructure lending, as summarized in Table 1 (Financial Stability Board, 2018). Phase I of the reform focused on increasing capital and liquidity requirements in general and Phase II of the reform adjusted the credit risk weight framework for certain asset classes. The flexibility of using internal measures of credit risk is largely constrained with an intention to aggregate to a more standardized approach that disallows issue-specific credit rating. For example, Basel III constrained the use of the internal ratings-based (IRB) approach and the internal estimates of credit conversion factors (CCFs) for IRB-non-revolving loans. Besides, the risk weights given to short-term exposures to banks are lower than longer-term exposures with the same external rating grades. Given that capital ratios are calculated as the percentage of risk-weighted assets, the potential overall increase in infrastructure projects' risk weights disincentivizes banks to provide funding.

Table 1: Regulations/standards Identified as Potentially Relevant to Infrastructure Lending

Regulations/Standards	Basel III Reforms	Effects on long-term lending
Minimum Capital Ratio	Raised by 2.5 - 7.5 pp points	Increase banks' funding costs
Minimum Leverage Ratio	Newly introduced	Does not allow risk migrants such as guarantees to reduce this leverage measure
Higher Loss Absorbency Requirements (HLA) for G-SIBs	Newly introduced	Disincentivize G-SIBs who are major players in financing infrastructure projects in developing countries
Liquidity Standards	Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) NSFR = ASF/RSF>1	NSFR makes it costlier to fund longer term loan (RSF) with short-term deposit (ASF) as it assigns long-term loan a 100% multiplier factor but a 50% multiplier factor to short-term loan
Large Exposures Regime	Limit a bank's exposure to a single counterparty or project to 25% of its Tier 1 capital	Constrain small banks' ability to finance infrastructure projects
Credit Risk Weight Framework	Constrained the use of internal measures of credit risk	Capital ratios are calculated as % of risk-weighted assets, increase in risk weights of infrastructure disincentivize banks to provide funding

Source: Financial Stability Board, 2018; Thomä & Gibhardt, 2019.

Both phases I & II would increase banks' funding costs and further raise the financing costs to loan borrowers. According to The Financial Stability Board (2018), the spread of the average cost of capital (WACC) over a risk-free rate would increase by 50 basis points for both advanced economies and emerging market portfolios. The reforms also reduced the lending maturities for banks and even more for G-SIBs, who are the primary provider of infrastructure financing.

11.4 Recommendations

The key to balance stability and access to finance is to employ targeted policies for qualified infrastructure and sustainable investment. The European Union has been relatively advanced in the policy field of targeting specific issues, as they have used the Small and Medium Enterprises (SME) supporting factor and are discussing a green supporting factor (GSF). Below are the potential solutions to incentivize long-term lending to sustainable development by learning from successful examples.

11.4.1 Targeted alteration to current capital requirements

To incentivize long-term banking, we might consider regulatory reforms. Regulators are responsible for balancing stability and access to finance, but their bottom line is to maintain systematic stability, and this need has been highlighted after the global financial crisis. Basel III measures aim to “strengthen the regulation, supervision and risk management of banks”, and tightened capital requirements will make banks more resilient to market shocks, reducing liquidity risk (BIS, n.d.). Therefore, proposing to relax the general capital requirements seems to not be the best course of action as it may harm the financial system's stability. The creation of new mechanisms, named the "green supporting factor" proposed by the European Parliament and Commission and the "brown penalizing factor” proposed by think-tank and non-governmental organizations, are promising in incentivizing sustainable loans. The green factor's basic idea is to reduce the risk weights by 25 percent for green investment under 1.5 million Euro and by 15 percent for investment over 1.5 million Euro; while the brown factor increases the capital requirements for high carbon, polluting, and other non-sustainable assets. "Combinations of a green supporting factor and a brown penalty could theoretically be designed to make the total capital requirement neutral so that any changes do not act as a levy or rebate on underlying risk" (SEB; White & Case; S&P Global Ratings; G20 SFSG, 2018). These models are based on the existing SMEs supporting factors, which reduced the capital requirement for small and medium enterprises from 10.5 percent to 8 percent.

Research estimated that at the EU level, these 15-25 percent GSF (equivalent to 1.05-1.75 percentage points increase in capital requirements) would free 3-4 billion Euro of capital reserves, reduce the cost of capital by 5 to 26 basis points for green projects, and reduce the lending to non-sustainable assets by up to 8 percent (Thomä & Gibhardt, 2019). However, there are debates among EU experts that GSF or the brown factor would make banks more vulnerable to insolvency risk, and this deviation from “the principle that capital requirements should be based solely on the riskiness of the underlying asset” would undermine financial stability (SEB; White & Case; S&P Global Ratings; G20 SFSG, 2018). Therefore, the cost and benefit of changes in capital requirements needs to be discussed thoroughly before implementation.

11.4.2 Targeted dual interest rates

The second potential solution is for central banks to employ targeted dual interest rates, which means that they explicitly offer long-term loans with lower or negative interest rates to commercial banks that use their loans to fund long-term sustainable investment. This idea originated from the European Central Bank (ECB)'s targeted longer-term refinancing operations (TLTROs) that aim to stimulate bank lending to the real economy (European Central Bank, n.d.). In the current TLTRO III operation, ECB provides three-year, low-interest loans to banks lending to non-financial corporations and households, and the more loans the bank issue, the lower the interest rate on their TLTRO borrowings becomes; the borrowing rate can be as low as 25 basis points below the average deposit rate. It also sets a borrowing allowance at 50 percent of a bank's outstanding eligible loans and a lending performance threshold, which has been reduced from 2.5 percent to zero percent in response to the Coronavirus crisis (European Central Bank, 2020).

Empirical analyses by ECB show that TLTROs have a positive impact on bank loan supply both directly– participating banks increase loan supply due to lower funding costs and indirectly – non-participating banks' operations affected by changes in the competitive environment of credit markets. Evidence also suggests that TLTROs do not lead to excessive risk taking (Andreeva & García-Posada, 2020). Bank of Finland estimated that TLTRO II increases bidding banks' stock of corporate loans by about 20 percent (Laine, 2019). A similar operation can be created to target bank lending to sustainable developments. Central banks could subsidize commercial banks' long-term lending to sustainable investment by offering a lower interest rate than the general policy rate, and carefully design the performance threshold and borrowing allowance to avoid risk-taking.

11.4.3 Tax shield

To increase the risk-adjusted returns of infrastructure loans, we could consider cutting tax for banks that lend to infrastructure projects. We have seen examples that tax-exempt instruments are attractive to commercial banks. The tax-exemption features of municipal bonds[11] in the US have contributed to the growth of this market, and banks were the primary purchaser of municipal debt (OECD, 2015), until a change in tax code in 1986, which prohibited banks from deducting the carrying-costs of tax-exempt municipal bonds. Instead, the code set an exception for "qualified tax-exempt obligation" that meets specific criteria about bond issuer characteristics and the aim of bond issuing. This kind of "bank qualified bonds" was still very attractive to banks but has limited supply (WM Financial Strategies, n.d.).

In fact, the Obama administration proposed the Qualified Public Infrastructure Bonds (QPIBs) as an expansion of the existing municipal bonds to allow the government to pay for public infrastructure projects (Farmer, 2015). We could further expand this policy: first, cover eligible private infrastructure and sustainable bonds to attract bank purchases by allowing interest incomes and capital gains from those bonds to be exempt from banks' taxes; second, grant tax-exemption on interests incurring from bank lending to eligible projects, set some restrictions on bond issuers, the uses of bond-financed capital, and borrowers to make sure the benefits are effectively used for sustainable development projects. We believe that this would significantly lower financing costs, as the AAA municipal bonds usually trade at a yield lower than US treasuries (OECD, 2015).

11.4.4 The need of a universal taxonomy

For a targeted operation to work effectively, a clear definition of the target is needed to avoid the misuse of incentivizing policies. In our case, the definition issue is challenging, and no universally recognized taxonomy sets standards and eligibility for sustainable assets (SEB; White & Case; S&P Global Ratings; G20 SFSG, 2018). In March 2020, the EU Technical Expert Group on Sustainable Finance published its final recommendation on the EU Taxonomy. The Taxonomy sets performance thresholds for economic activities that make a substantive contribution to environmental objectives, do no significant harm to the other five defined in the regulation, and

[11] The interest on municipal bonds is often (but not always) exempt from federal income tax. The interest may also be exempt from state and local taxes if you reside in the state where the bond is issued or if the bond is issued by a U.S. territory. (SEC)

meet minimum safeguards. Once implemented, the EU Taxonomy "will have wide-ranging implications for investors and issuers working in the EU, and beyond". In December 2019, the EU agreed on the Taxonomy Regulation at the political level, creating a legal basis for the EU Taxonomy (European Commission TEG, 2020).

12. Non-financial Companies

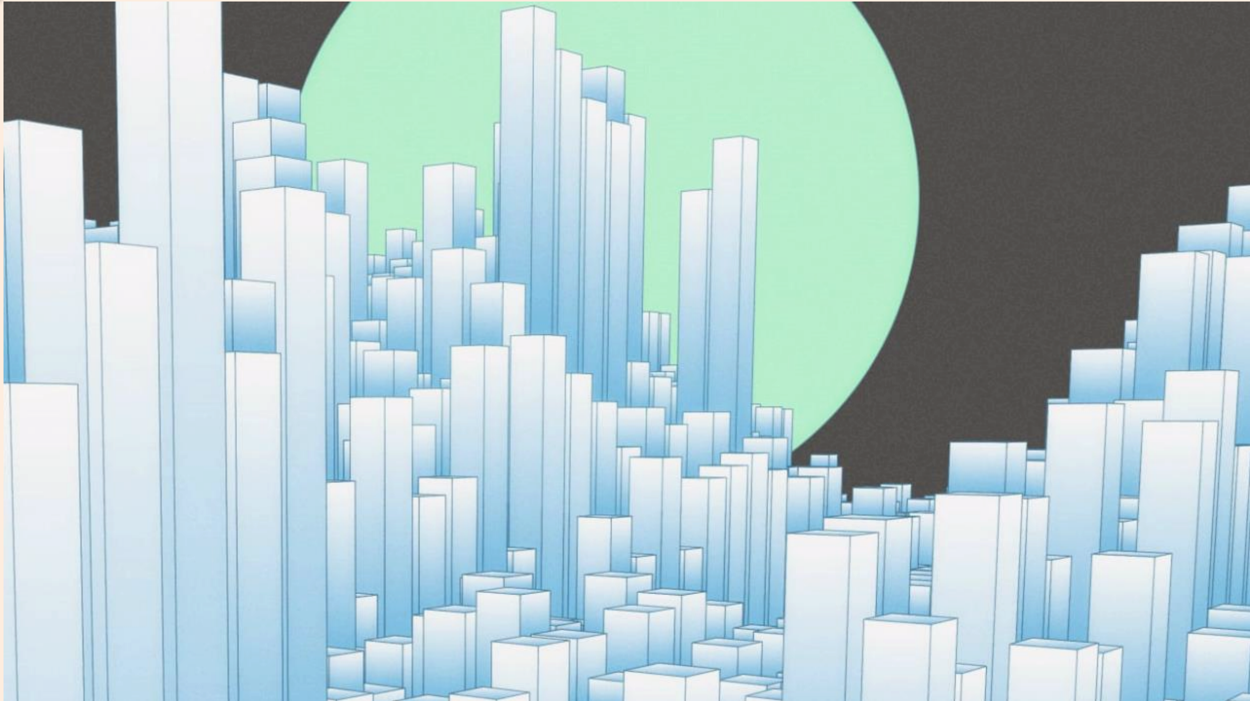


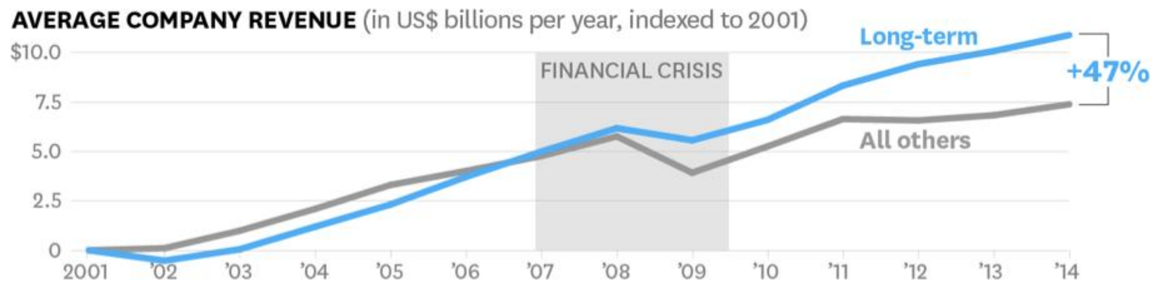
Illustration Credit: World Press

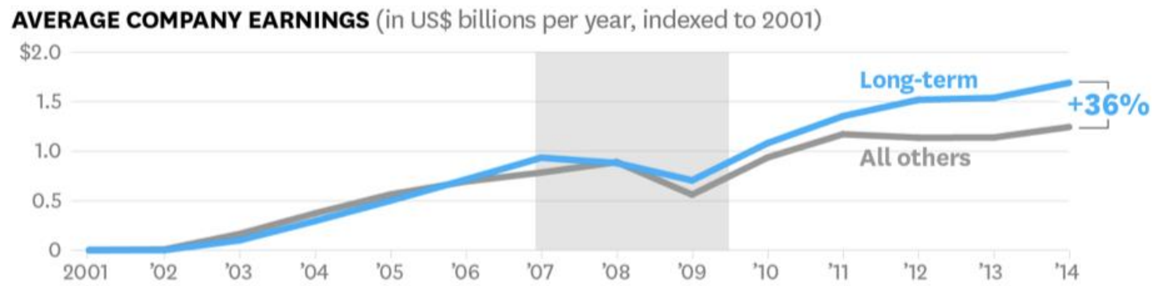
12.1 Introduction

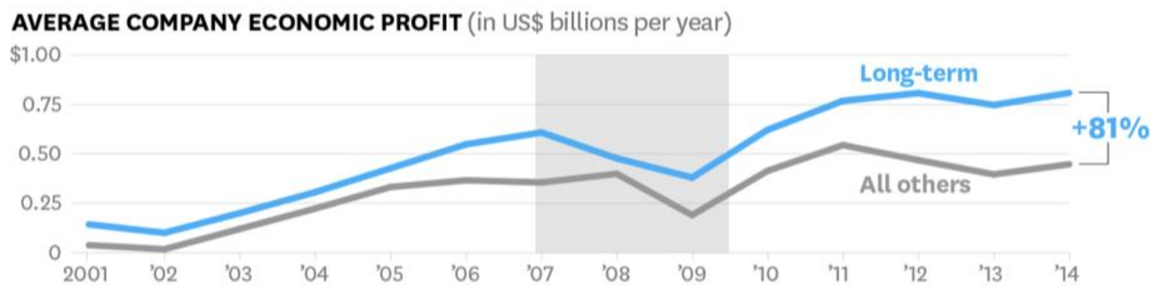
We define non-financial corporations as producing goods and (non-financial) services. Non-financial companies and their boards have debated their sustainability strategies (or lack-thereof) for a number of years. Companies' interest in the integration of sustainable practices to create long-term value for shareholders has been in part encouraged by the focus of large private equity firms like Blackrock and its $10 billion Long Term Private Capital (LTPC). The fund holds investments in firms embracing long-termism and their holding period return is beyond seven years. In 2017, research from McKinsey Global institute further made the business case for companies to embrace long-termism, the examination of the performance of 615 companies managed with the long-term value creation in mind, outperformed their short-term-focused peers on several financial metrics as well as created considerably more jobs.

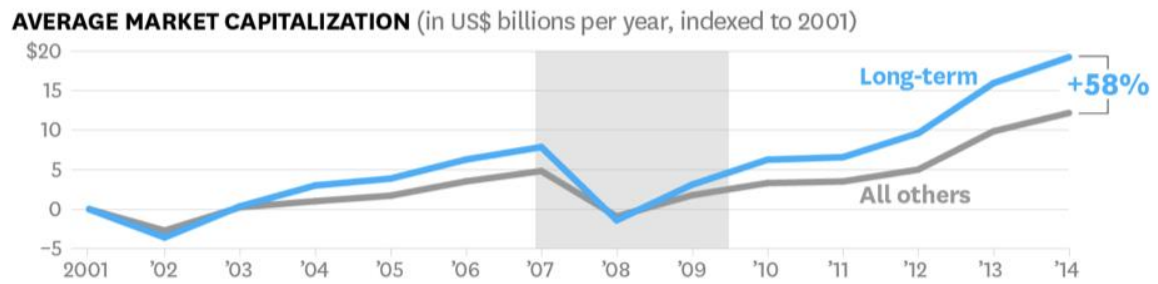
Figure 9:Long-term Gains for Company Revenue, Earnings, Profit, Capitalization, Job Creation

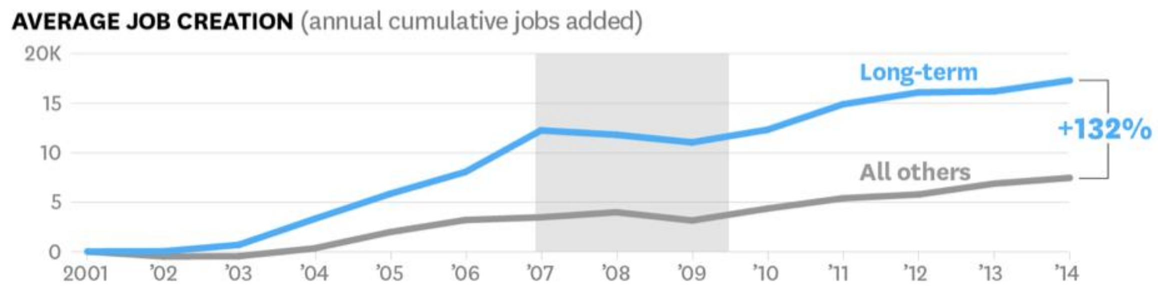
The Data: Where Long-Termism Pays Off











SOURCE MCKINSEY GLOBAL INSTITUTE
FROM "THE DATA: WHERE LONG-TERMISM PAYS OFF," BY DOMINIC BARTON, JAMES MANYIKA, AND SARAH KEOHANE WILLIAMSON, MAY–JUNE 2017

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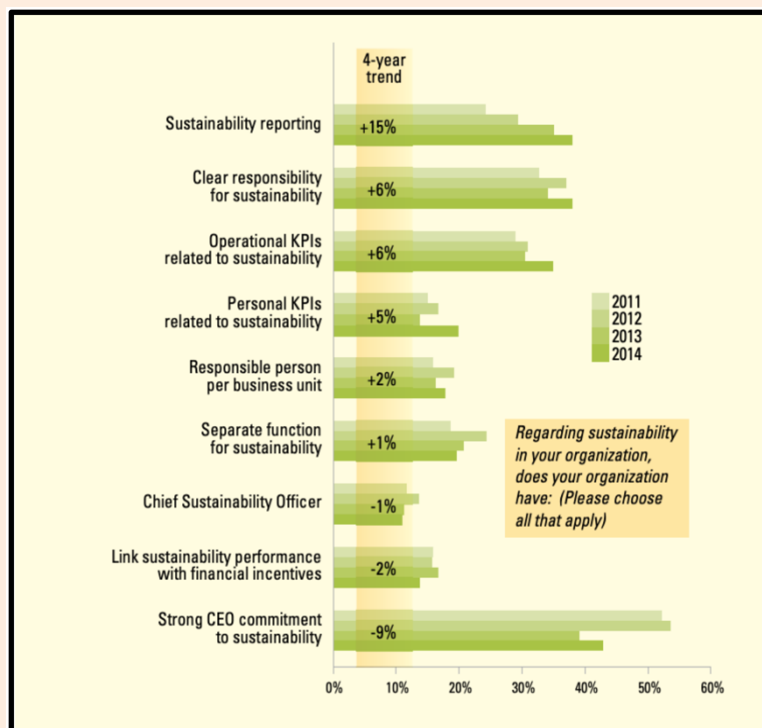
Source: McKinsey Global Institute

While corporations are increasingly seeking best practices when it comes to board governance, sustainability performance, and social impact, others avoid assessing their sustainability impacts and favor the publication of their philanthropic and community engagement efforts instead. It is unlikely that a lack of enlightened leadership is at fault, but rather it is probable that the materiality of short-term profits presents less risks than managing with a long-term view. To increase the number of companies adopting long-termism, the tangibility of its benefits needs to be clear. To that end, the Sustainability Accounting Standards Board materiality framework, could help companies' management establish links between financial materiality and progress towards the SDGs. (Betti, 2018) Arguably, as non-financial companies all face sustainability challenges on a global scale that are pivotal to their growth, these corporations need a systemic approach.

12.2 Current Environment

An increasing number of companies have been disclosing sustainability reports, highlighting responsibility and sustainability KPIs. Figure 10 shows that from 2011 to 2015, the number of companies who have sustainability reports increased 15 percent due to the adoption of defined responsibilities of sustainability KPIs (the number of sustainability-related KPIs increased six percent) (Cusack, 2017). Sustainability initiatives have become more institutionalized and structured. Increasingly, a larger number of companies have incorporated internal structures or business units to deploy firmwide sustainability efforts, rather than insulated initiatives created in isolation by the CEO.

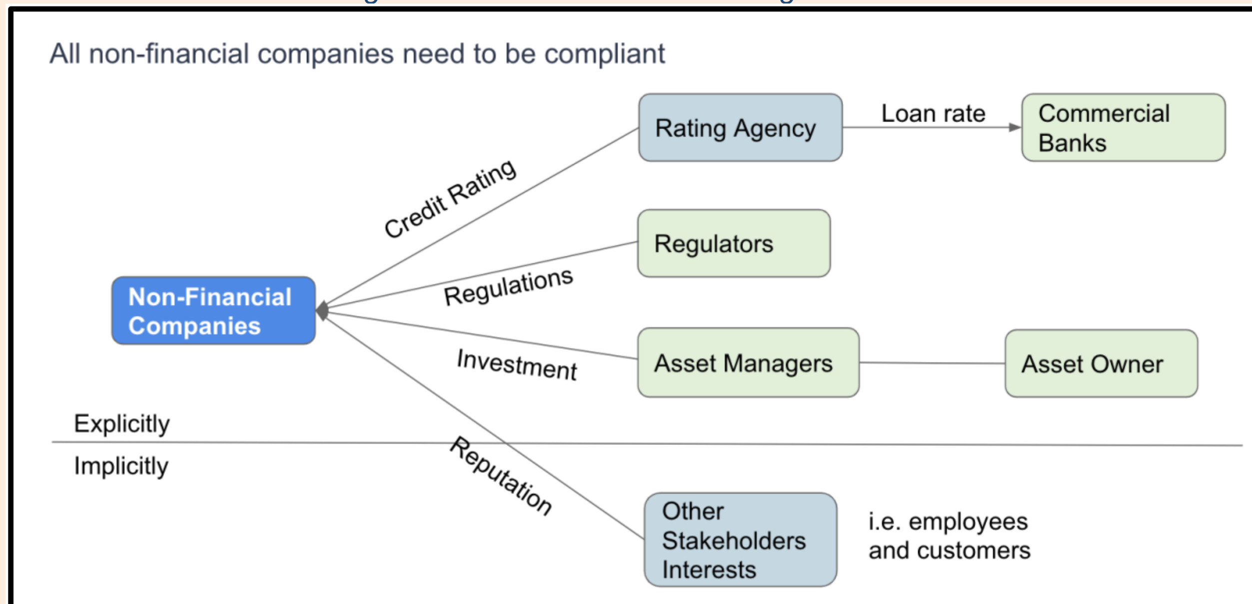
Figure 10: Companies' Sustainability Report Increase Due to Adoption of Sustainability KPIs



Source: MIT Sloan BCG, June 20, 2017. Julie Cusack, Sustainability Study

In Figure 11, we summarize all the incentives and reasons that non-financial companies want to run long-termism strategies. These incentives can be divided into explicit and implicit reasons.

Figure 11: NFC Incentives for Long-Termism



Source: authors of this research

12.2.1 Explicit Incentives

All non-financial companies need to be compliant to external restrictions from commercial banks, rating agencies, regulators, asset managers and asset owners.

12.2.2 Credit Rating and Bond Rating

A long-termism strategy can increase the likelihood of long-term value of a company, contributing to robust investment grade credit rating and lower its borrowing costs. Non-financial companies' cost of borrowing is based on their bond rating or credit rating. The sustainability of a companies' earnings is an important factor affecting credit rating or bond rating. A study from Hanyang University Business School studying the relationship between ESG scores and bond pricing found that positive ESG scores can contribute to lower issuer funding cost for relatively small firms. Empirical data also shows large investors help accelerate ESG integration among small firms with higher information asymmetry and external funding needs (Jang, 2020).

Another study, by Pornsit Jiraporn, Napatsorn Jiraporn, Adisak Boeprasert, Kiyoung Chang, found that an improvement in CSR by one standard deviation increases the credit rating of the company by as much as 4.5 percent (Jiraporn, 2013). This result is consistent with other studies correlating the adoption of CSR with other positive externalities such as earnings forecasting unbiasedness (Leonardo Becchettia, RoccoCicirettib, AlessandroGiovannelli, 2012) or increased financial returns. While the CSR-performance relation changes over time (periods of economic expansion vs. periods of contraction), there is evidence highlighting the long-term

benefits of CSR on financial performance. (Erin H.Kao, Chih-ChuanYeh, Li-HsunWang, Hung-GayFung, 2018).

12.2.3 Compliance

Short-termism undermines inclusive prosperity by fostering asymmetric information, a central problem to Nobel Prize winner George Akerlo (Akerlo, 1970). Public companies are particularly vulnerable to the pressure of producing quarterly earnings that meet analysts' expectations. To meet these expectations, some managers may be tempted to engage in short-termism to raise current earnings and inflate their company's short-term earnings to signal higher long-run value. (Jrasuric, 2015). It is critical that compliance with industry regulations and norms designed to mitigate asymmetric information as well as agency problems, be enforced. To that end, incorporating artificial intelligence to collect and analyze a swath of data and foster transparency aiming to eliminate asymmetric information would mitigate short-termism.

12.2.4 Business Performance

As mentioned in the introduction, the 2017 McKinsey study contrasted the success of short relative to long-term focused businesses. (AESC) Factors identified as essential to outperformance of leading organizations were: the organization's vision, increased market share, brand value recognition, employee and product/service performance, focus on sustainability, and stakeholder satisfaction as a result of strategies with 5 to 10 years horizons. Equally remarkable were the contributions to society and the overall economy. The study reported that long-term managed businesses gained almost 12,000 more workers on average than their peers from 2001 to 2015.

There are merits of communicating the firm's earnings strategy and results while linking them with ESG strategy and by extension long-termism as per Rodney Zemmel, the Managing Partner of Northeast (US) at McKinsey & Co (AESC) and co-author of "Go Long: Why long-term thinking is your best short-term strategy", which advocates communicating quarterly financial results linking financial performance to ESG indicators to inform customers, external partners, investors, and employees.

12.2.5 Risk Mitigation

Long-termism investment strategy can mitigate long term risks, strategy risks, operational risks, principal agent related risks and external risks.

12.2.6 Partnering with long-term Investors

Companies' long-term strategies have achieved competitive returns for general partners (GPs) of private equity firms specialized in long-term value creation with a 5 to 10-year base case, with less risks and less volatility. Companies with robust long-term corporate strategies, often times founder-led, family-owned companies, valuation between $.5 billion and $1.5 billion, not interested in raising capital through auctions (less sensitive to price but more interested in long-

term value growth) are a good fit for such private equity firms that are able to mobilize patient capital (typically very high net worth investors) achieving competitive returns over the long-run because in part, long-term investments are not eroded by high management fees and the compounding effect of recycling capital/profits and the cash flow from the investee companies (non-financial firms) can be used to buy new companies without incurring new capital costs. Efficiency gained allows the PE firm to underwrite the acquisition of companies embracing long-termism. (Blackrock, 2019) Said differently, PE firms commit long-term liquidity to allow firms to lever up their balance sheet to facilitate the transformational acquisition of companies recognizing value in long-termism that have high upside potentials.

12.2.7 Implicit Incentives

Companies' sustainability affects their reputation and their ability to retain talent and anchor customer loyalty.

12.2.8 Brand Recognition

Building robust client partnerships and trust with vendors; providing ongoing value to society and adding value to the business all contribute to position the companies to achieve economic, social and environmental sustainability in the long-run.

12.2.9 Attract more talents and build long-term leadership

Communicating commitment to long-term strategies signals credibility, engages employees to leverage their intellectual capital to achieve common goals, fosters cooperation within and outside the firm to achieve efficiencies and long-term gains.

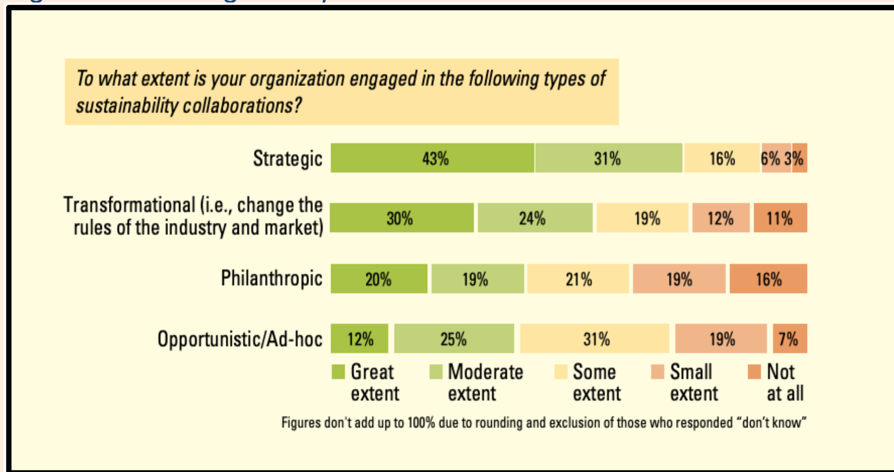
12.3 Challenges and Incentives

Non-financial companies face three challenges to achieve sustainability:

12.3.1 Companies need to work together

Sustainability objectives are complex to attain, and many companies face strategic and transformational issues to achieve them. Figure 12 highlights that strategic and transformational cooperation are essential towards achieving sustainability (Cusack, 2017).

Figure 12: Strategic Cooperation is Essential to Achieve Sustainability



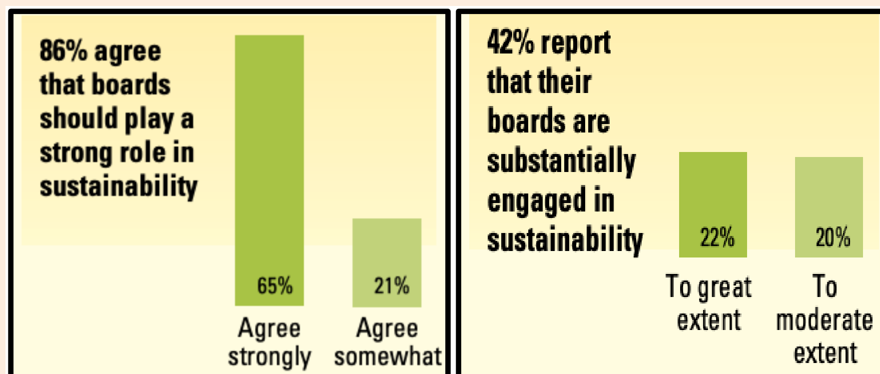
Source: MIT Sloan BCG, June 20, 2017. Julie Cusack, Sustainability Study

Our research finds that non-financial firms recognize that global sustainability problems, affect long-term profitability. Solving global sustainability challenges requires cooperation, solutions are increasingly multifaceted, particularly if sustainability requires forgoing short-run profits. For partners and competitors to cooperate towards solving long-term sustainability challenges, their goals must align.

12.3.2 The board has to bridge the "knowing – doing gap"

While companies recognize that sustainability matters, few of them have adopted a long-term strategy. 90 percent of managers consider sustainability to be relevant but only 60 percent of businesses integrate sustainability into their supply-chain operations, and 25 percent have embedded sustainability practices in their business model. Equally telling, The MIT Sloan BGB study (Cusack, 2017) shows that while 86 percent believe that company boards have an important role to play, only 42 percent acknowledge their board's engagement.

Figure 13: Knowing vs. Doing of Sustainable Engagement

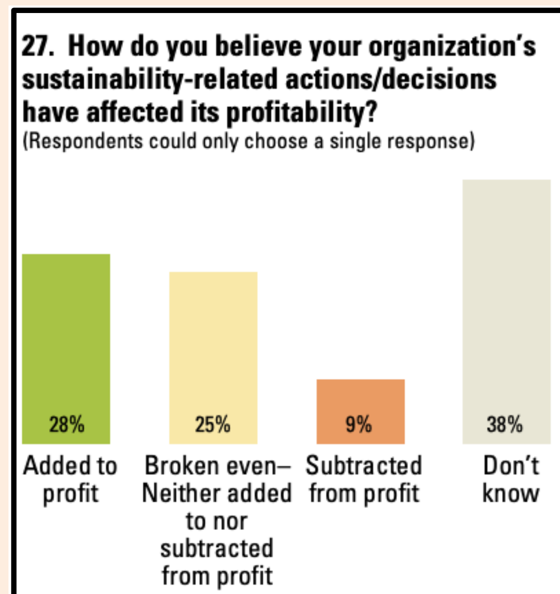


Source: MIT Sloan BCG, June 20, 2017. Julie Cusack, Sustainability Study

12.3.3 The compliance and competitive advantage difference

Some companies still consider sustainability a passive strategy and do not believe sustainability strategy leads to superior returns (Cusack, 2017).

Figure 14: Many NFC's Believe Sustainable Practices Add to Profit



Source: MIT Sloan BCG, June 20, 2017. Julie Cusack, Sustainability Study

12.4 Recommendations

Factors contributing to companies' adoption of long-term strategies as an alternative to a corporate focus on short-term results:

12.4.1 Increased Information Disclosure

Standardize companies' non-financial disclosures to include data relevant to the SDGs. Disclosure details of the firm's implementation of its long-term strategy, goals and the materiality of non-financial factors most relevant to the firm. Inform stakeholders of the firm's progress implementing long-termism and its strategic impact towards achieving the SDGs.

Using the SDGs as a backdrop, include non-financial disclosure metrics capturing the gains achieved with long-termism as they relate to product innovation, brand recognition, customer satisfaction and supply chain management. Non-financial companies can also signal/list the suppliers which cooperated best with their long-term value creation strategy. The pros and cons of using a scoring system capturing the relationship between long-termism and its impact on the 17 SDGs. Note these non-financial disclosures could be available on a rolling basis on the companies' website. Progress need not wait until the publication of quarterly or annual reports to be published. Online rolling basis communication with stakeholders provides a live feed of critical data, engaging all stakeholders of the firm around sustainability. The availability of up-to-date

information related to long-termism would influence the investment level of asset owners, the loyalty of suppliers and customers and the firm's competitors' own commitment to long-termism.

12.4.2 Align business strategy and sustainability

Companies need to engage their board more effectively towards long-termism. While it was a strong feature of debate in the years preceding COVID-19, the pandemic has forced companies to be reactive to the urgency at the expense of focusing on the long-term. When the pandemic will be contained if not eradicated, governments will be further in debt and with fewer ammunition to support firms in their adoption of long-termism. Hence, the necessity for company boards to steward a profound change towards strategies and operations that embrace long-termism. In a study, 67 percent of respondents suggested that collaborations were successful in organizations where boards are viewed as committed supporters. The rate of success in industries where the board is not involved is less than half.

Companies' board adoption implies that from the top down, long-termism will permeate decisions at all levels of firms' operations and mobilize all employees. Encouraging bottom-up flow of ideas and initiatives generating long-term value creation with impact would also complete a virtuous circle of processes aligned with long-termism. It would create a firm ecosystem mending profitability and sustainability. Cooperation within and outside the firm as crucial in shaping solutions to mitigate risk, foster profits and produce social and environmental impact.

12.4.3 Increased transparency in internal operations

Principals, shareholders and other stakeholders' interest could be asymmetric. The alignment or prioritization of these interests can be cemented by transparency of the firms' strategy to create long-term value with social and environmental impact. Transparency would also anchor prudential and non-prudential regulations towards sustainability, highlight industry norms towards accountability and guide regulations when necessary.

Mandating "sustain-ability" disclosure as part of corporate annual report is a "modest starting point" recommended by Prof. Jill E. Fisch (Making Sustainability Disclosure Sustainable, 2019). Under her proposal companies would be required to identify and explain the top three sustainability issues to their operations. While expressing openness to elements of disclosure, other experts, on issues related to corporate governance and disclosure, like Alexandra M. Ledbetter, a Senior Corporation Finance Counsel in the SEC's Office of the Investor Advocate, favor a policy solution that reflect consensus among all stakeholders, particularly investors. They favor a disclosure framework that would speak directly to investors' financial interests rather than one determined by companies' management. For investors, the materiality of factors having a long-term social impact, the "S" in ESG, is likely not aligned with companies' profitability targets. Companies and investors' lack of consensus on long-termism and a sustainability disclosure requirement framework, highlights the necessity first, to align mandated sustainability factors with existing reporting framework and standard areas of overlap. Hence, companies' sustainability reporting needs to align with stated risk adjusted strategies as well as asset managers' fiduciary duties.

Boards' reflection about the materiality of the changes to be considered to adopt long-termism is critical in shaping the firms' overall strategy. Indeed, boards have to consider the materiality of all the factors impacting its short-term and by contrast its long-term profitability, their corresponding social and environmental impact, review their relevance for their diverse shareholders market (index trackers, activist hedge funds, private equity, etc.) and establish their seniority in anticipation of the trade-off that might be necessary to take to create long-term value for the firm. Boards need also consider that changing macro-economic factors may impact the materiality of factors targeted towards long-termism. Arguably, the COVID-19 pandemic, global crises in general, challenge long-termism by putting stress on long-term goals predicated on data and expectations that are no longer relevant or realistic (Dyson, 2020).

To reconcile all stakeholders' interests, it might be necessary for the incentive structures to separate companies' responsibility to manage risk, from their aim to maximize returns. Doing so would enable to pursue both dimensions to the desired level, and manage overlapping timelines, ranging from short-term risk/return to long-term risk/return (Corporate Finance Institute, better-alignment project, 2020).

13.Regulators

Illustration Credit: World Press

13.1 Introduction

A number of regulatory impediments prevent asset owners from embracing long-termism. Research aforementioned in this paper have highlighted the risk mitigation, value creation, social and environmental benefits and opportunities derived from long-termism. There seems to be

reluctance from regulators to define in legal terms what constitutes long-termism and sustainability. Legal and regulatory changes require consensus building and political engagement that takes months and sometimes years to complete. With that consideration in mind, this section will discuss some legal regulatory options drawn from U.S. and non-U.S. regulators, it will also focus on non-legal recommendations to promote long-termism and normative changes that would incentivize market participants to adopt long-termism.

13.2 Current Environment

13.2.1 Non-Financial Reporting Disclosures

13.2.1.a European Regulation

European Union (EU) law requires large companies to disclose certain information on the way they operate and manage social and environmental challenges. This helps investors, consumers, policy makers, and other stakeholders to evaluate the non-financial performance of large companies and encourages these companies to develop a responsible approach to business and to further encourage long-termism. Non-financial Reporting Disclosures (Directive 2014/9/EU) lays out the rules on disclosures of non-financial and diversity information by large companies (European Commission Non-Financial Reporting, n.d.). This directive amends the accounting directive 2013/34/EU. Companies are required to include non-financial statements in their annual reports from 2018 onwards (European Commission Non-Financial Reporting, n.d.). The law mandates that companies with more than 500 employees report. This includes non-financial companies, banks, insurance companies, public interest companies, etc. They are required to disclose policies they implemented related to environmental protection, social responsibility, treatment of employees, respect for human rights, anti-corruption/bribery and diversity on company boards (Harper Ho, 2020).

Photo Credit: European Commission

Companies may use international, European or national guidelines to produce their statements. For instance, they can rely on UN Global Compact, OECD guidelines for multinational companies, ISO 26000. In June 2017, The European Commission published its guidelines to help companies disclose environmental and social information (European Union Commission Guidelines on Non-Financial Reporting, n.d.). These guidelines are not mandatory and companies may decide to use international, European or national guidelines according to their own characteristics or business environment. In June 2019, the European Commission published guidelines on reporting climate-related information, which in practice, consisted of a new supplement to the existing guidelines on non-financial reporting (European Union Commission Guidelines on Non-Financial Reporting, n.d.). These voluntary disclosures that have been implemented in the EU would be beneficial to nudging the financial sector to shift priorities to long-termism.

13.2.1.b U.S. Regulations

While waiting for regulators to agree on legal terms defining long-termism and sustainability, a regulatory strategy might be to encourage companies to define those themselves. It would be a pathway to manage and achieve their long-term focus based on their own business model. In the interim, the advancements made to legally define ESG investments can be a reference point to further progress to define long-termism and when necessary regulate it.

In the United States, demand for a standardization of ESG disclosures is also rising among investors and other corporate stakeholders, and sustainability issues are gaining visibility among corporate boards. In 2018, institutional investors representing USD $5 trillion in assets under management teamed up with leading securities and corporate law scholars to urge the U.S. Securities and Exchange Commission (SEC) to undertake new rulemaking on ESG disclosure (Williams & Fisch, 2018), and a climate risk disclosure bill was introduced in the Senate.[12] In 2019, new proposals on ESG disclosures were introduced in the House of Representatives, and the SEC opened the door to expanded disclosure on human capital.[13] However, significant barriers to the adoption of non-financial reporting reforms remain (Harper Ho, 2020).

The U.S.'s approach to ESG disclosure, which relies largely on private ordering, still diverges so visibly from the reform paths adopted elsewhere. Key reasons for this divide are the deep roots of shareholder primacy in U.S. business practice, and a greater skepticism towards regulation in some quarters of the U.S. polity. In addition, corporate issuers' fears of over-aggressive shareholder enforcement, legal obstacles to new disclosure regulation, and the nature of the current disclosure regime constrain the prospects for federal disclosure reform and will define the contours of any future non-financial disclosure rules (Harper Ho, 2020). Given these institutional starting points, non-financial disclosure in the United States will continue to depend heavily on private ordering, and absent Congressional support, any regulatory change is better to be **justified on traditional economic grounds** rather than on stakeholder concerns or on an intent to change corporate practice.

Although the current rules that apply to mandatory reporting under the federal securities laws already require companies to disclose certain environmental and social information, non-financial reporting in the United States is largely market-driven. Any nudges towards long-termism will likely need to be market-driven (rather than legal per se). Some non-financial information does reach investors, regulators, and corporate stakeholders through corporate annual reports, proxy statements, and other public filings, but the largest public corporations provide non-financial disclosures primarily in free-standing sustainability reports, in corporate surveys, and in response to **direct engagement between investors and corporate management** (Lukomnik, Kwon, &

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[12] Climate Risk Disclosure Act of 2018, 115 S. 3481, 2018 S. 3481.

[13] ESG Disclosure Simplification Act of 2019, H.R. ___, 116th Cong. (discussion draft); Shareholder Protection Act of 2019, H.R. ___, 116th Cong. (discussion draft); Corporate Human Rights Risk Assessment, Prevention, and Mitigation Act of 2019, H.R. ___, 116th Cong. (discussion draft); To require issuers required to file an annual or quarterly report under the Securities Exchange Act of 1934 to disclose the total amount of corporate tax such issuer paid in the period covered by the report, and for other purposes, H.R. ___, 16th Cong. (discussion draft); Climate Risk Disclosure Act of 2019, H.R. 3623, 116th Cong. (discussion draft). All available at: https://docs.house.gov/Committee/Calendar/ByEvent.aspx?EventID=109770). In August 2019, the SEC partially responded to several rulemaking petitions by including human capital disclosure in proposed amendments to risk disclosures under Item 101(c) of Regulation S-K (SEC, 2019).

Welsh, 2018). Indeed, in recent years, **shareholder activism** has become one of the primary catalysts of rising corporate board attention to non-financial/ESG issues or long-termism in the United States (Harper Ho, 2018: 420–423; Huennekens & Smith, 2018). In the absence of new regulatory guidance, a wide range of private actors drive the proliferation of reporting standards and frameworks for voluntary non-financial disclosure; many of these, including the Global Reporting Initiative (GRI), the Task Force on Climate-related Financial Disclosure (TCFD), and the Extractive Industries Transparency Initiative, are the same sources that inform non-financial reporting practice for European companies. U.S. companies also participate in **voluntary regimes**, such as the Global Compact and various environmental or social certification programs, which also encourage sustainable business practice, disclosure, and a shift towards long-termism.

Although private actors dominate the landscape of non-financial reporting in the U.S., many of the reporting requirements under the federal disclosure laws already potentially require non-financial disclosure, as the SEC noted in its 2010 Guidance on Climate-Related Risk (SEC, 2010). These include rules requiring disclosure of material changes to the business, disclosure of certain environmental compliance costs, and disclosure of material legal proceedings.[14] In addition, **companies must discuss ESG risks if they are among the material risk factors for the company**,[15] and Management's Discussion and Analysis must also provide a narrative discussion of "any known future trends or uncertainties" that could materially affect the firm's financial performance.[16] All of these encompass material environmental and social risks, even though the SEC has not yet adopted any specific disclosure rules on ESG risks, nor do any of the current rules specifically mention environmental or social risk factors. In addition, the federal proxy rules governing the information that companies must provide in advance of a shareholder vote include elements that may relate to firms' ESG risk management function. For example, Item 402(s) of the Sarbanes-Oxley Act of 2002 requires disclosures on how the company's risk management practices relate to executive compensation if those practices are "reasonably likely to have a materially adverse effect on the company," and Item 407 requires a description of board diversity policies.[17] Beyond specifically required disclosure, companies must also report any other information, including non-financial information, that is "necessary to make the required statement, in light of the circumstances … not misleading."[18]

In addition to these general disclosure rules, the SEC has adopted certain "specialized disclosure" rules under the 2010 Dodd Frank Act that pertain to social or human rights concerns. Specifically, these rules mandated disclosure of mine safety and government payments by extractive sector firms, the use of conflict minerals, and business activities in Iran.[19] However, worthy of note is that

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[14] 17 C.F.R. § 229.101(a)(1) (2018); 17 C.F.R. § 229.101(c)(1)(xii) (2018); 17 C.F.R. § 229.103 (2011).

[15] 17 C.F.R. § 229.105 (2019).

[16] 17 C.F.R. § 229.303(a)(3)(ii) (2019).

[17] 17 C.F.R. §§ 229.402(s), 229.407(c), (h) (2019).

[18] Securities Act Rule 408, 17 C.F.R. § 230.408 (2001); Exchange Act Rule 12b-2017 C.F.R. § 240.12b-20 (2013); 15 U.S.C. §§ 78a–78qq (2012).

[19] Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111–203, §§ 1502–1504, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78 m (2018)); 17 C.F.R. § 229.104 (mine safety); see also Conflict Minerals, 77 Fed. Reg. 56,274 (September 12, 2012); Mine Safety Disclosure, 76 Fed. Reg. 81,762 (December 28, 2011). Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112–158, § 219, 126 Stat. 1214,

specialized disclosure have faced stiff resistance from the business community, and some of these rules have been invalidated following legal challenges.[20] However, as discussed below, leveraging these existing regulations in the U.S. can assist the GISD in getting closer to achieving long-termism.

13.2.2 Non-Financial Disclosure Reporting Reform

Until recently, the SEC's revisions to its disclosure regime have largely ignored ESG and long-termism related issues. Responses to the 2016 Concept Release and statements from many reporting companies, trade associations, law firms, and industry groups like the U.S. Chamber of Commerce and the Business Roundtable, also reveal that many do not believe non-financial disclosure gaps exist or that new approaches to non-financial disclosure are necessary (Harper Ho, 2020). To date, neither Congress nor any of the U.S. stock exchanges have adopted any non-financial reporting measures.[21] However, the current administration has signaled its support to climate-related and environmental, social, and governance (ESG) disclosure issues. In March 2021, the SEC announced[22] that its staff would be evaluating climate change-related disclosure rules and asked for public input on such disclosure and the creation of a Climate and ESG Task Force in the Division of Enforcement charged to proactively identify potential ESG-related misconduct and disclosure violations. On March 15, 2021, the SEC's Acting Chair Lee announced that the SEC staff would be evaluating climate change-related disclosure rules and asked for public input on such disclosure. Meanwhile, the US Department of Labor (DOL) announced that it would not enforce Trump-era DOL rule amendments that require ERISA plan fiduciaries to select investments based solely on "pecuniary factors."

13.2.3 Private-Sector Regulating

March 11, 2021, John Coates, the Acting Director of the SEC's Division of Corporation Finance, issued a statement[23] emphasizing that ESG factors are increasingly relevant to investment and voting decisions and that ESG Disclosures needed to keep pace with developments affecting investors, public companies and the capital markets. He recommended the creation of an effective ESG disclosure system that is "adaptive and innovative". Until then, private-sector self-regulation may more successfully contribute to long-termism. Investors, advocacy organizations, financial regulators outside the U.S., and international organizations continue to draw attention to sustainability issues and non-financial disclosure among investors, in corporate boardrooms, and among corporate and securities law scholars. Private standard setters, such as the Sustainability Accounting Standards Board (SASB), the Climate Disclosure Standards Board (CDSB), and the

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1235–36 (2012). The SEC's final rule on Payments to Governments by Resource Extraction Issuers, Exchange Act Release No. 34–78,167 (2016), was repealed February 14, 2017 by Pub. L. No. 115–4, 131 Stat. 9.

[20] https://www.degruyter.com/view/journals/ael/ahead-of-print/article-10.1515-ael-2018-0043/article-10.1515-ael-2018-0043.xml#j_ael-2018-0043_fn_004_w2aab3b7b8b1b6b1ab1b2b3b2b3Aa, AND Ibid.; see also National Association of Manufacturers v. SEC, 800 F.3d. 518 (D.C. Cir. 2015) (striking down portions of the Dodd-Frank conflict mineral rules).

[21] In 2017, President Trump issued an Executive Order aimed at limiting new regulations of any kind, reflecting the current deregulatory climate. Reducing Regulation and Controlling Regulatory Costs, Exec. Order No. 13,771, 82 Fed. Reg. 9339, January 30, 2017.

[22] https://www.sec.gov/news/public-statement/lee-climate-change-disclosures?utm_medium=email&utm_source=govdelivery

[23] https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121

work of the Financial Stability Board's Task Force on Climate-related Financial Disclosure (TCFD) have raised awareness of ESG materiality and provided tools for companies to use when disclosing material non-financial information within their annual reports. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has also been instrumental in promoting better ESG risk management and in 2018 developed guidance for how ESG-related risks (and long-termism risks) should be addressed within its enterprise risk management framework (COSO, 2018).

International developments, such as the European Non-financial Reporting Directive, the United Kingdom's Stewardship Code and the European Commission's sustainable finance initiatives are also raising attention to ESG issues among U.S.-based companies and inspiring new private-sector initiatives. For example, voluntary stewardship guidelines for U.S. investors, which were developed by a coalition of institutional investors, were inspired by the U.K. Investor Stewardship Code (ISG, 2018). **Institutional investor pressure is now perhaps the single most important driver of changes in non-financial disclosure practice in the United States and in the level of attention U.S. corporations pay to the strategic and financial implications of environmental and social issues** (Harper Ho, 2020). Investor activism typically makes use of shareholder proposals and the proxy process as well as investor surveys and direct shareholder communications with management (Bauer, Moers, & Viehs, 2015; Haan, 2016).

Recent proxy seasons have seen rising support for environmental and social shareholder proposals, with some winning majority support (Ernst & Young, 2019; Mueller, Ising, & Briggs, 2018). Although **shareholder proposals** are non-binding in the U.S., they are widely used to promote dialogue between investors and management and to prompt changes in corporate practice and in environmental and social transparency (Bauer et al., 2015). They have a high likelihood of being used to promote long-termism. Mainstream investor support for ESG proposals has risen as Blackrock, Vanguard, Fidelity and others have joined state public pension funds and other traditional supporters of ESG initiatives in adopting voting policies that are supportive of certain ESG proposals. Investor voice is further amplified by **proxy advisory firms**; for example, the 2019 voting policies of leading proxy advisors Glass Lewis and Investor Shareholder Services (ISS) signal support for most common environmental and social proposals, and Glass Lewis' policies condition support for director candidates on the extent to which the board has active oversight of ESG issues (Glass Lewis, 2019; ISS, 2019). At the same time, relying on an ad hoc campaign-style approach to corporate reform is costly to activists and to corporations and is also far less effective at standardizing reporting practices than it may be at raising the visibility of ESG issues among corporate boards and executives (Harper Ho, 2018: 444–456).

It is also worth noting that in the private sector, asset managers must comply with legal obligations for both conduct and prudential purposes defined by various national and transnational regulatory bodies, which may assist with incentivizing long-termism. Asset managers also have transparency obligations; however, those transparency obligations do not include how they do the following (which, if done, will incentivize long-termism):

Illustration Credit: WP-Contents

- Monitor investee companies on relevant matters, including strategy, financial and non-financial performance, risk, capital structure, social and environmental impact and corporate governance;
- Make investment decisions based on assessments about medium to long-term financial and non-financial performance of the investee company and to engage with investee companies in order to improve their performance in the medium to long-term;
- Price their performance and their remuneration for asset management services to be in line with the profile and duration of the liabilities of the AOs, in particular long-term liabilities, and take absolute long-term performance into account;
- Conducts dialogues with investee companies;
- Exercises voting rights and other rights attached to shares;
- Cooperates with other shareholders and other stakeholders of the investee companies; and
- Manages actual and potential conflicts of interests in respect to their engagement.

13.3 Challenges and Incentives

Some of the main challenges that we have identified as it pertains to regulation are shareholder

primacy, fear of regulatory costs, legal obligation, skepticism in regulation, fears of overaggressive shareholder enforcement, being beholden to "two masters," and in the U.S., the fact that non-financial regulation is largely market-driven. Below is a discussion of the challenges for regulators in regulating or achieving long-termism in the financial sector.

Illustration Credit: World Press

13.3.1 Lack of readily available ESG information and common definitions of long-termism

Investor responses to the SEC's 2016 Concept Release on disclosure reform (SEC 2016) and surveys of mainstream institutional investors since then confirm rising investor demand for ESG information that is not currently being met by the level of disclosure in corporate annual reports (Ernst & Young, 2017; Vasantham & Shammai, 2019). Of course, *nearly all of the largest publicly traded companies produce free-standing sustainability reports, most based on the same reporting framework – the* ***Global Reporting Initiative (GRI) Standards*** (Ceres, 2018; KPMG, 2017; Lukomnik, Kwon, & Welsh, 2018). But even with common frameworks, voluntary reporting does not harmonize or standardize disclosure. This is because **voluntary reporting frameworks like the GRI allow companies to adopt stakeholder-oriented definitions of materiality that can be defined by each company and that do not align with the investor-oriented definition of materiality established under U.S. federal securities laws**. Sustainability reports are also subject to many well-known limitations that make them inadequate as a source of investment-grade information: they are **generally not assured**, and the flexibility they offer to reporting companies comes at the expense of the comparability, consistency, and reliability that characterizes information contained in public filings (TCFD, 2016; Harper Ho, 2018: 447–52; CII, 2019). In short, **public companies face growing demand for material ESG information that**

is not readily available either in companies' annual reports or through other public sources.

13.3.2 Shareholder Primacy

Shareholder primacy, or the idea that shareholders should be the primary concern for boards and publicly traded companies presents challenges for long-termism. As Sjåfjell, Johnston, Anker-Sørensen, and Millon (2015) have noted, the strong influence of shareholder primacy on U.S. business culture is perhaps the primary reason why regulators, financial institutions, and corporate boards alike hesitate to urge companies to disclose more non-financial information and to pay attention to the social welfare effects of corporate activity on stakeholders and long-termism. To be sure, state corporate governance rules in the United States emphasize director's autonomy in decision-making and give directors discretion to sacrifice profit, so long as they are acting in the best interests of the corporation and its shareholders and the company is not "on the auction block" (Bainbridge, 2003; Elhauge, 2005; Stout, 2012: 27–44). There are also emerging indications of greater openness to stakeholder-oriented corporate governance reform in the U.S., of which the GISD can capitalize to incentivize long-termism. For example, in August 2019, the Business Roundtable, which represents some of the largest public companies and has been most stridently opposed to non-financial reporting reform, released a statement on the purpose of the corporation that affirmed the importance of stakeholder constituencies (Business Roundtable, 2019). Even the state of Delaware, whose corporate code governs most Fortune 500 companies in the United States, has gotten on the sustainability bandwagon – in 2018, it passed legislation allowing companies to obtain a "**sustainability certification**" from the state if they voluntarily adopt sustainability reporting standards and assessment measures (Harper Ho, 2020).

But it is far from clear that these developments signal a fundamental reorientation of U.S. business culture and practice. The view that corporations are creatures of private contract whose primary purpose is to maximize shareholder wealth has a long history among U.S. corporations and many other international companies, businessmen, and academics (Friedman, 1970; Roe, 2001: 2065, 2073; Fisch, 2006: 654–55). From a normative perspective, shareholder primacy also rests on widely accepted economic rationales that still loom large for both corporate managers and regulators. Chief among them are that agency costs will rise as corporate managers are charged with following the marching orders of **"two masters" – shareholders and other stakeholders** – and that public welfare is best served when corporate managers work to maximize the value of the corporation rather than catering to the interests of competing stakeholder constituencies (Easterbrook & Fischel, 1991:38). Chief Justice of the Delaware Supreme Court, Leo Strine, has also made clear his view that under Delaware law, "within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare" (Strine, 2015: 771). This creates a challenge particularly for long-termism.

This notion that corporate directors' and officers' consideration of stakeholders is permissible solely to advance shareholder interests, essentially requires corporate directors and officers to identify a business case for focusing on stakeholder impacts. In contrast, the "enlightened shareholder value" perspective of the U.K. 2006 Company Act defines fiduciary duties to

corporate shareholders to include consideration of stakeholder interests (Keay, 2013). This endorsement of the importance of stakeholder interests may explain the greater willingness of U.K. regulators to promote non-financial reporting, even though, as a matter of corporate governance, the **United Kingdom gives shareholders even greater power in corporate governance than they hold under most U.S. state corporate statutes** (Bruner, 2010; Keay, 2015: 120).

13.3.3 Cost- efficiencies and Political Considerations

Financially material issues are of grave concern to investors and determine whether or not they invest in the short- or long-term. Financially material matters are issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors. There is some regulation which states that stakeholder impacts must raise a threat of serious economic or "financially material" impact in order to act on them. Under the securities laws, the U.S. Supreme Court has defined materiality in terms of the significance of that information to *investors*, not other stakeholders.[24] In contrast, materiality under the E.U.'s non-financial reporting directive is designed to aid *all users* of the disclosure in understanding the "impact of the [company's] activity" (EC, 2017: 5). For most U.S. public companies, stakeholder impacts, such as human rights violations, must raise a real threat of significant economic impact or regulatory risk to the company itself before they could be considered financially material. For some of the largest firms, their sheer size means that even extremely large transactions or risk events may not be financially material and will not be disclosed (Georgiev, 2017).

Similarly, the fiduciary duty standards for employee pension funds, which also inform the standards that govern public pension funds and other U.S. institutional investors, only permit them to engage in ESG integration and activism to the extent such efforts are **cost-efficient** and reflect a prudent determination that they are reasonably likely to enhance economic value (DOL, 2015; DOL, 2018). **This rule reflects the core economic emphasis of pension fund fiduciary duties and is a more modest approach to ESG issues than the requirements under the European Commission's Occupational Retirement Provision Directive, or the laws of Sweden, Norway, and Germany, which mandate some combination of ESG integration into risk management processes or investment decisions** (UNPRI & MSCI, 2016: 14).

Comments to the SEC's 2016 Concept Release from companies, trade associations, and other business organizations affirm the strength of shareholder primacy in the U.S. Even though the vast majority of investor responses stressed that ESG information is material to shareholders' investment, voting, and engagement decisions, many corporate respondents questioned the notion that any ESG issues could be material for purposes of the U.S. federal securities laws (Harper Ho, 2020: 39–40). These responses often included strong statements about the "political" or "special interest" nature of ESG information and urged the SEC to reject any efforts to let itself be hijacked in service of these goals. For example, a coalition of 43 state attorneys general

[24] The U.S. Supreme Court's standard established in TSC Industries, defines information as material if there "is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or "that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information" available to the investor in reaching a voting or investment decision. Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988), quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

echoed the common view that existing materiality standards should already elicit non-financial disclosure and expressed concerns that climate change disclosure mandates are promoting a political agenda where shareholder activists use their power to advance the "social cause du jour" Pruitt & attorneys general, 2016.[25] Such arguments resonate with some current SEC Commissioners. In 2018, SEC Commissioner Peirce cautioned that any attempt to identify material ESG factors that might be the subject of disclosure reform would open a Pandora's box of potentially burdensome regulatory mandates, necessitating choices among stakeholders that "introduce uncertainty and political influence into corporate operations" (Peirce, 2018). Clearly, many companies, as well as regulators at both the state and federal levels, still stand to be convinced that non-financial information is material to investors. But unless they are, reforms of the U.S. federal disclosure rules and implementation of long-termism will continue to face an uphill battle.

13.3.4 Disclosure reporting and increased risk

There has been more success with disclosure reporting in Europe than in the United States. An initial reason why the SEC has been hesitant to introduce non-financial reporting reforms is that companies are exposed under the federal securities laws to private enforcement through shareholder litigation, as well as agency enforcement, for allegedly fraudulent or misleading statements or material omissions (Harper Ho, 2020). In many other international jurisdictions, principles-based disclosure is the norm, and corporate governance and disclosure rules have been adopted on a comply-or-explain basis that allows companies to deviate from a recommended best practice if they provide an explanation for the deviation (FRC, 2012). Research on the effectiveness of comply-or-explain approaches finds that shareholder litigation over inadequate or missing explanations is relatively rare (EC, 2011: 191; Keay, 2014). While this may leave reporting obligations more weakly enforced under such a regime than they would be in the U.S. system, it also reduces the perceived legal risk companies face if reporting obligations are expanded. However, U.S. companies and trade associations have strongly resisted any expansion of mandatory disclosure in Regulation S-K, not only because of the potential costs of new reporting obligations, but also because new mandatory disclosures increase the risk of shareholder litigation for alleged securities fraud (Harper Ho, 2020: 33–34).

13.3.5 Non-financial reforms

Although corporate self-regulation, shareholder activism, and private standard-setters have all helped push companies to produce sustainability reports and have raised the visibility of ESG issues as a corporate governance concern, private ordering alone is simply not suited to streamlining and standardizing the content and form of disclosure in the way that disclosure mandates can (Harper Ho, 2018). The SEC already has at its disposal several possible steps short of rulemaking that could incentivize better disclosure of material ESG information and thus,

[25] The view that ESG issues simply reflect particular social or even political agendas is perpetuated to some extent by the securities laws (Harper Ho, 2019). Under the federal proxy rules, shareholder proposals that pertain to the "ordinary business" of the corporation can only proceed to a shareholder vote if they raise a "significant policy issue." SEC Staff Legal Bulletin (SLB) (2017), No. 14I (CF), November 1, 2017, https://www.sec.gov/interps/legal/cfslb14i.htm (explaining 17 C.F.R. § 240.14a-8(i)(vii)).

long-termism in corporate annual reports. The SEC could issue new guidance, building on its 2010 Climate Guidance to further standardize disclosure of material climate-related risks, perhaps endorsing the TCFD framework and the use of sector-specific indicators. The SEC could also go further by encouraging the use of other private frameworks that base their ESG risk indicators on the securities laws' definition of materiality, such as the SASB standards or the CDSB reporting framework. Other alternatives include using its practice of case-by-case disclosure review and comment letters to focus issuers' attention on non-financial reporting gaps. However, while these efforts should encourage more companies around the world to identify ESG information as material and to include it in their public filings, none of these possibilities can promote the kind of consistency and comparability that investors demand from ESG disclosure.

Illustration Credit: World Press

13.3.6 Digitalization of Regulation Systems

As noted above, there has recently been significant regulatory development to accomplish ESG and SDG goals that promote long-termism in the lead of advanced countries, such as the EU and the United States. However, there also has been a mixed response among policy makers, regulators and media commentators to their current regulatory frameworks, despite advanced countries' efforts to create regulatory frameworks (Paddy, et al, 2018). One of the main reasons behind this response is the lack of technological and digital development of the regulatory system to accommodate the current international disarrangement of standards. Moreover, in the case of low and middle-income countries, they lack the regulatory framework that matches with the standards of advanced countries. Under these disparate ESG standards in different countries, the digitalization of the regulation system has limits to evolve because imprudent technological development might cause more gaps in standards among different countries.

13.4 Recommendations

13.4.1 Shift from voluntary reporting to Mandatory reporting

The Financing for Sustainable Development Report 2020, prepared by over 60 international agencies from the UN system and beyond, recommended the adoption of global mandatory disclosures on climate-related financial risk like those promoted by the Task Force on Climate-related Financial Disclosures (TCFD). Regulatory frameworks would "enable a proper assessment of corporate contribution to the SDGs, but also penalize unsustainable practices and discourage short-term thinking in capital markets (IISD 2020)."

13.4.2 Set standards promoting the convergence of financial and non-financial reporting standards, using consistent key performance indicators (KPIs) linked to the SDGs

There is little question that reporting on KPIs can and should be integrated into mainstream financial reporting. If KPIs are to serve a useful role in driving fundamental change in business practices, their implications for the core business operations and its finances need to be spelled out and understood. There is a grave need for quality and meaningful KPIs that connect to long-termism. Only 23 percent of multinational companies' sustainability reports connect the SDGs to numerical performance indicators, and "without numbers, sustainability reporting quickly becomes a public relations exercise." The variety in type of information makes it difficult to compare different companies' data. In order to achieve long-termism, it is crucial that every company has the same information for reporting. For example, Canada has pioneered an approach in which companies receiving financial assistance for crises like the COVID-19 pandemic must commit to stricter reporting requirements on socioeconomic issues, as well as carbon reduction targets (IISD 2020). Integration of these KPIs with financial reporting can help address one of the chief concerns about sustainability reporting today. Integrated reporting helps to inform companies' decision-making by identifying potential financial and non-financial risks and rewards within their operations and allowing investors and other stakeholders to understand how sustainability issues play out in the day-to-day decision making about the basic operations of a company. Additional work needs to be done to better understand where and how KPIs could most usefully be integrated into financial reporting with the lens of long-termism. GISD can work with stakeholders or advocacy partners such as the Committee of Sponsoring Organizations of the Treadway Commission (CSOTC) to create universal principles that can promote a norm of long-termism in different regulatory regimes. GISD can develop quality and meaningful KPIs that they would like as industry standards.

Illustration Credit: World Press

13.4.3 Blend of mandatory and voluntary reporting

Some scholars have suggested that regulatory bodies can mandate a narrative "Sustainability Discussion & Analysis" from corporate management, along the lines of the current Management Discussion & Analysis (MD&A) and Compensation Discussion & Analysis (CD&A) rules (Fisch, 2018), the management report required under the E.U. accounting directives, or the U.K.'s strategic report. However, such an approach unnecessarily duplicates elements of the MD&A, such as forward-looking assessments of significant risks and trends that should already incorporate material ESG risk disclosure. And like the MD&A and CD&A, any narrative discussion is also of less value in promoting comparability than prescriptive indicators.

Instead, non-financial reporting reform should adopt a tiered approach that balances prescriptive and principles-based reporting to incentivize long-termism. A tiered approach would include a limited set of mandatory common indicators or principles-based disclosures that would apply across all sectors. Cynthia Williams and Jill Fisch, for example, have proposed to the SEC, in line with the TCFD's recommendations, that disclosures relating to ESG risk management and governance should apply broadly to all issuers and go beyond existing governance disclosures (Williams & Fisch, 2018: 13; Harper Ho, 2020). Other disclosures beyond this "first tier" could be subject to materiality judgments or might be required only for certain issuers or sectors. The TCFD's climate-related disclosures and the Singapore and Hong Kong stock exchanges' ESG reporting frameworks offer useful models of this kind of tiered approach. For instance, the Hong Kong stock exchange's disclosure rules require some disclosures, such as greenhouse gas emissions reporting, from all public companies, but encourage companies to voluntarily disclose other indicators; the Hong Kong model currently allows even mandatory indicators to be reported

on a comply-or-explain basis (HKEx, 2019). In the U.S., any such reforms would supplement or amend current environmental, governance, and risk factor disclosures, which do not specifically mention climate-related risks, ESG-related indicators, or ESG risk management.

Where greater comparability and consistency is required, for example, with respect to specific indicators of climate-related risks, **line-item rules will be more effective**. However, one of the biggest practical barriers to more precise line-item disclosure, even for widely accepted issues like greenhouse gas emissions or climate-related risk management, is the question of which ESG/SDG indicators are material. This challenge is heightened by the fact that ESG materiality is often sector-specific and likely to evolve over time (Barker & Eccles, 2018), raising the specter of ever-expanding disclosure burdens. One solution is to defer to issuers' own materiality determinations, but this perpetuates under-reporting of ESG information. Alternatively, the specific content of such disclosures could be drawn from existing reporting frameworks, such as the SASB materiality standards, or could incorporate such frameworks by reference, leaving to certain private standard setters the task of identifying material indicators over time. Under this more flexible approach, standardization could still be achieved if the SEC endorsed or identified the specific private standards that could serve as the basis for disclosure, or engaged in a kind of "meta-regulation" of private standards by specifying features a standard must have for it to be relied upon in a company's public filings (Parker, 2002). These could include, for example, requirements that the standard be internationally recognized, aligned with the Supreme Court's definition of materiality, and informed by ongoing industry and stakeholder engagement.[26]

13.4.4 Comply or Explain

In light of the challenges of cost-benefit analysis and issuer concerns about the burdens of new reporting mandates, any prescriptive rules the SEC develops as part of these reforms should apply to issuers on a more flexible comply-or-explain basis. For example, the SEC could require companies to disclose whether they had adopted policies and procedures to assess climate risk or to explain why they did not; similarly, domestic regulatory bodies could mandate reporting of greenhouse gas emissions, but allow companies to omit such a disclosure if they explained why such disclosures were not material. Comply-or-explain provisions are not the norm in the U.S, but they have, in fact, already been introduced to a limited extent by Congress over the past decade (Harper Ho, 2020).

Because comply-or-explain approaches are also a form of private ordering and rely on shareholder enforcement to police the sufficiency of companies' responses, they might find a more welcome reception in a U.S.-context that heavily favors private ordering, flexibility, and shareholder monitoring. At the same time, adopting new rules on a comply-or-explain basis also allows regulators to identify baseline disclosures or practices that should generally be followed by reporting companies. Although comply-or-explain regimes are often weakly enforced (Keay,

[26] For example, the SEC has already endorsed compliance with voluntary frameworks and foreign regulations as a kind of safe harbor in its Order Recognizing the Resource Extraction Payment Disclosure Requirements of the European Union, Canada, and the U.S. Extractive Industries Transparency Initiative as Substantially Similar to the Requirements of Rule 13q-1 Under the Securities Exchange Act of 1934, 81 Federal Register 49,163, July 27, 2016. Other examples include its endorsement of the COSO internal control framework (SEC, 2003).

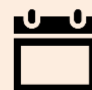
2014; Moore & Petrin, 2017: 63), the implementation of Sarbanes Oxley's few comply-or-explain provisions by U.S. companies (Rodrigues & Stegemoller, 2010: 7), as well as evidence from other jurisdictions, suggests that enforcement is likely to be more robust in markets like the U.S. where shareholder litigation and active shareholder engagement is common (Harper Ho, 2017; Klettner, 2017). This suggests that allowing firms to report on a comply-or-explain basis could improve comparability and corporate practice by setting a basic standard for firm conduct or disclosure content, while allowing flexibility for companies who cannot provide such disclosures or for whom the baseline standard is not efficient, which both contribute to the goal of long-termism.

13.4.5 Adopt global reporting standards and use consistent terminology

Without the information needed to provide insight into sustainability factors, users across all parts of the system cannot properly assess the performance or prospects of companies or funds. According to Morgan Stanley research, 70 percent of surveyed asset managers felt that the industry lacks standard metrics to measure nonfinancial performance of sustainable investments.[27] This hinders their ability to quantify impact and hinders progress on reporting on long-termism indicators. Some of the common issues faced by those seeking to incorporate a better understanding of sustainability risk and opportunity into investment decisions include: 1) a lack of common frameworks, standards and definitions leading to a lack of consistency, including in the labelling of products; 2) significant data gaps through failure to disclose, in particular where reporting is left to voluntary approaches rather than mandatory; and 3) a lack of enforcement of existing requirements. Joint action is required to close the information gap, a prerequisite for effective integration and alignment of sustainability and finance.

13.4.6 Identify an international and digitalized regulatory single point access

There is a critical need for all financial parties to be able to access regulation and reporting to streamline reporting requirements and increase transparency. If transparency in reporting is increased, asset managers, asset owners, and others will be incentivized to report on key SDG indicators. The Bank of International Settlement could house this digital access point, for example and this initiative could be supported by a GISD or the UN agenda. Additionally, having a single, international, and digitalized regulatory access point will lower costs and increase efficiencies.



13.4.7 Implement a "Sustainability" section as part of a "yearly report" (not annual report) for Asset managers

Asset managers need one formal regulation that addresses opportunities of long-termism as well as the risks of short termism in order to create an industry norm. This can be done by requiring a new "Sustainability" section as part of their Yearly Report. This yearly report is not an annual report as it can be completed at any point during the year. We suggest yearly reporting (i.e. not putting something in an *annual report*) because we recognize the slow-moving nature of yearly reports. Requiring SGD reporting in the Annual Report risks investors needing to rely on outdated information. Further, previous SIPA capstone work has identified that breaking the cycle of annual

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[27] https://www.morganstanley.com/press-releases/morgan-stanley-sustainable-signals--asset-owners-see-sustainabil

reporting was beneficial to incentivize long-termism (Cao, Ching-Tsung Wei et. al. 2019).

13.4.8 TCFD or other body could "certify" sustainability reports for extra layer of compliance/signaling

Certifying sustainability reports is a recommendation for an extra layer of authenticity. It is crucial that the finance industry is all operating on the same playing field. Having one or two regulatory actors that conduct certifications of sustainability or long-termism would allow the industry to take long-termism more seriously.

13.4.9 Implement online and ongoing reporting of transparency disclosures

Another important aspect is online (ongoing reporting), which includes expanding on the definition to include more transparency disclosures. Asset managers must comply with legal obligations for both conduct and prudential purposes defined by various national and transnational regulatory bodies, while also having transparency obligations.

The following gaps in these transparency obligations suggest a need for disclosures in this ongoing reporting on:

a. Disclosures about efforts to monitor investee companies on relevant matters, including strategy, financial and non-financial performance, risk, capital structure, social and environmental impact and corporate governance;
b. Disclosures about investment decisions based on assessments about medium to long-term financial and non-financial performance of the investee company and to engage with investee companies in order to improve their performance in the medium to long-term;
c. Disclosures about the pricing of their performance and their remuneration for asset management services are in line with the profile and duration of the liabilities of the AOs, in particular long-term liabilities, and take absolute long-term performance into account;
d. Disclosure about dialogues with investee companies; about their exercise of voting rights and other rights attached to shares
e. Disclosure about cooperation with other shareholders and other stakeholders of the investee companies; and how they manage actual and potential conflicts of interests in respect to their engagement.
f. The yearly reports can disclose information on policies related to environmental protection, social responsibility, respect for human rights, anti-corruption, and how much they invest into each SDG category
g. The recommendation related to regulators with regards to asset managers, may be to require disclosures relative to these issues as part of their transparency obligations through industry associations like the Alternative Investment Management Association (AIMA), the National Association of Active Investment Managers (NAAIM), the European Fund and the Asset Management Association (EFAMA)) to adopt them as best practices. This will set a new standard for asset managers to disclose publicly on their website (being updated regularly) how these issues and potential conflicts of interests were internally reviewed and mitigated; and most importantly how they were factored into their investment strategy. The resulting transparency would signal to the market which asset managers

best reduced their investment decisions based on short-term returns to the benefit of long-term risk mitigation and returns.

The important thing to note about these yearly reports, ongoing reporting, and single access points is that reporting needs to be more easily compared across industries, consistent between industries/companies, and content reported should focus on long-termism.

13.4.10 Give asset managers, asset owners, non-financial companies the option to use domestic or international standards for voluntary or mandatory reporting

Asset managers, asset owners and non-financial companies will be more incentivized to report on long-term metrics and key performance indicators if they have the option to use domestic or international standards for voluntary or mandatory reporting. Some regulatory options that could be given to these groups to use are the UN Global Compact or the OECD guidelines. Giving these groups more options will increase flexibility and enable them to have more agency in their disclosures.

13.4.11 Incentivize asset managers, asset owners, and non-financial banks to communicate to the market that having "two masters" will not increase costs, is "non-political," and is "non-special interest."

There should be market signaling/communication to find a way to ensure that SDG long-termism reporting is verifiably neutral, non-political, and non-special-interest based. Market actors will be more incentivized and likely to switch to long-termism and SDG reporting if they can show that reporting to shareholders and socially conscious stakeholders is in alignment with everyone's goal of increased return and decreased risk. The GISD can lead by example here. The CEOs of the GSID companies could publicly announce that they and their board members are vouching for the accuracy of their "sustainability report" in the yearly or online report to show that there is minimal burden of this SDG reporting and therefore no need to have an additional "master" being stakeholders. GISD advocates can also be a mouthpiece for signaling that investing in the long-term actually increases returns (as discussed in length in the asset owners' section above).

13.4.12 Create GISD legal working group to leverage existing regulatory frameworks

Encourage GISD to form legal working groups to leverage existing legal requirements in capital markets to foster an alignment with the SDGs and long-termism. For example, in the U.S., GISD partners could see how to leverage the risk management practices required disclosures of Sarbanes-Oxley or "specialized disclosures" of the Dodd-Frank Act (Harper Ho, 2020). In the U.S., the Sarbanes-Oxley could be used as a launching point to require more SDG reporting. Item 402(s) of the Sarbanes-Oxley Act of 2002 requires disclosures on how the company's risk management practices relate to executive compensation if those practices are "reasonably likely to have a materially adverse effect on the company," and item 407 requires a description of board diversity policies. Beyond specifically required disclosure, companies must also report any other information, including non-financial information, that is "necessary to make the required statement, in light of the circumstances … not misleading" (Harper Ho, 2020).

The Dodd-Frank Act's requirement of "specialized-disclosures" could be used as the SEC has adopted certain "specialized disclosure" rules under it that pertain to social or human rights concerns. Specifically, these rules mandated disclosure of mine safety and government payments by extractive sector firms, the use of conflict minerals, and business activities in Iran (Harper Ho, 2020). Specialized disclosures have faced stiff resistance from the business community, but GISD members could start to encourage these disclosures in the U.S. context.

In addition, again in the U.S. context, the SEC could issue new guidance building on its 2010 Climate Guidance to further standardize disclosure of material climate-related risks, perhaps endorsing the TCFD framework and the use of sector-specific indicators. The SEC could also go further by encouraging the use of other private frameworks that base their ESG risk indicators on the securities laws' definition of materiality, such as the SASB standards or the CDSB reporting framework. However, it is recommended that a professional GISD legal working group is formed to examine existing international legal frameworks to leverage for long-termism.

13.4.13 Widen the Definition of Fiduciary Responsibility

On November 13, 2020, the U.S. Department of Labor updated its regulation and expanded the definition of ERISA fiduciary investment duties of an ERISA fiduciary in selecting either direct plan investments or investment alternatives to make available to participants and beneficiaries of self-directed plans (the "Investment Duties Regulation") (Feurer, 2020). This permitted ERISA fiduciaries to consider ethical factors such as business enterprises' policies regarding social, economic, health, environmental, justice, sustainability, climate change or corporate governance to make investment decisions. The Regulation permits this as long as those considerations do not reduce an investment's expected economic performance (ibid). However, there are still challenges ahead. The Regulation, unlike the earlier DOL regulations, "prohibits the managers of a Qualified Default Investment Alternative (QDIA) from a self-directed plan, such as many 401(k) plans, from being too overt in pursuing ethical factor investing" (ibid). These challenges aside, it appears there has recently been a shift towards regulatory frameworks that are more favorable to asset managers interested in adopting long-termism as their dominant strategy. GISD should consider strategies to further expand definitions of fiduciary responsibility in whatever legal frameworks possible to promote changes of achieving and incentivize long-termism.

14.Least Developing Countries (LDCs)[28]

14.1 The business case for long-termism and impact investment in developing countries

Since 1956, the most diversified international impact investor, the International Finance Corporation (IFC), earned superior returns by investing in emerging markets and developing nations. While as a member of the World Bank Group, the IFC can leverage sizeable political and financial capital that other funds cannot, between 1961 and 2019, its private equity and

[28] The UN defines least developed countries as "low-income countries confronting severe structural impediments to sustainable development. They are highly vulnerable to economic and environmental shocks and have low levels of human assets."

venture capital investments in emerging markets and developing economies (130 countries) have yielded 15 percent more that if invested in the S&P 500 during the same period (Cole, Melecky, Mölders, & Reed, 2020). This performance was achieved along with strong social returns using long-term strategies, making the business case for long-termism investment strategies to be deployed in emerging markets and developing economies. Moreover, the interest rates in developed economies have dropped to nearly zero, whereas developing countries have relatively high rates, encouraging free capital to search for potential investments all over the world (Trading Economics, n.d.).

Illustration Credit: World Press

14.2 Challenges and Incentives

14.2.1 The already large SDGs financing gap in LDCs is widening after COVID-19

After the COVID-19 crisis, the investment gap for LDCs to achieve the SDGs is expected to widen, as external private finance inflows are severely impacted - dropping by USD 700 billion in 2020 than in 2019 (OECD/UNCDF, 2020). According to OECD (2020), the SDG financing gap in developing economies was estimated to be USD 2.5 trillion in 2014, but after the pandemic crisis, an additional 15.4 percent of these countries' GDP would be needed to fill in the gap.

14.2.1. Long-term Investment Concerns

OECD/UNCDF (2020) lists a series of common risks and barriers to private investment in developing countries. Some of them are systematic, long-term risks that cannot be avoided, but some of the risks can be addressed by modern techniques or financial instruments.

14.2.2 Depth of capital markets

The underdeveloped or non-existent capital market in LDCs is often viewed as the barrier to raise enough local capital for sustainable development. However, this opens the door for international investors to provide external finance and earn good returns. Cole, Melecky, Mölders, & Reed (2020) found that investment returns decline within economies as their banking sector deepens.

14.2.3 Lack of collateral

International bank loans also play an essential role in financing the development of LDCs. However, few participants in LDCs have enough assets as collateral to banks.

14.2.4 Foreign exchange risk

Most of the revenue generated in LDCs are in local currencies, thus creating potential losses to USD investors due to the local currency's depreciation against US dollars. Hedging measures such as currency swaps are usually used to handle foreign exchange risks in countries with a relatively developed financial market.

14.2.5 Systemic risk (including country risk), weak governance, and regulatory risks

Many LDCs face a high risk of debt distress and low credit rating. The ease of doing business and regulatory environment is especially important for many public private partnerships (PPP) projects where private investors work closely with local governments. Yet Cole, Melecky, Mölders, & Reed (2020) argued that country risk factors do not significantly predict financial returns; instead, the forecast of macroeconomic fundamentals matter the most in risk assessment.

14.3 Recommendations

Credit or risk guarantee mechanisms can significantly reduce the uncertainty of investment returns and attract commercial investment in LDCs. According to OECD/UNCDF (2020), guarantees mobilized the highest share of private finance in LDCs: 62 percent in 2015-2016 and 46 percent in 2017-2018. The guarantee can be sourced from the local government, strong advanced economies, and international organizations. For example, IFC offers partial or full guarantees to cover risk payments for trade transactions through the global trade finance program (GTFP); USAID issued a guarantee to facilitate the issuance of the world’s first sustainable land-use bond in Indonesia (OECD/UNCDF, 2020); World Bank MIGA provides political risk insurance and credit enhancement for cross-border private sector investors and lenders.

Other risk mitigating tools can be pooled investment vehicles that manage risks within a diversified portfolio and achieve greater mobilization to scale up investments, such as contingent convertible bonds (COCO bonds). In Europe, COCO bonds allowed banks to meet capital requirements and postpone interest payments or even write down the debt to zero. For example, in 2014, Switzerland’s Credit Suisse issued a $2.5bn COCO bond that could be written down to zero if the bank’s capital ratio fell below 5.125 percent or a viability event happened at the discretion of the regulator (Financial Times, n.d.). Furthermore, research shows that COCO bonds designed with write-down features mitigate default risk similar to

equity, and with conversion features reduce the volatility of bank asset value (Hau & Hrasko, 2018). Similarly, fixed income instruments loans bought by asset owners/managers from LDCs may be structured like COCO bonds, allowing turning the debt into equity if facing financial difficulties. However, it may be challenging to issue COCO bond debt in LDCs given the instrument's complicated structure and countries' underdeveloped capital markets. Consequently, further exploration is needed on the feasibility of COCO bonds as a financial instrument in LDCs.

OECD/UNCDF (2020) found that private finance mobilized in LDCs is concentrated in revenue-generating sectors, such as energy and financial sectors. We suggest that future investments explore opportunities from an ESG angle to pursue a Net Zero Economy.

15.Conclusion

This report identified obstacles impeding asset owners, asset managers, commercial banks, non-financial companies, and regulators from adopting "Long-termism" as well as actionable recommendations for these actors to embrace it. Our analyses using data obtained from our desk research and expert interviews, has made the business case that investments and business strategies seeking long-term value creation, manage better the materiality of climate, social, and government risk and are expected to yield better results than their peers.

To promote long-term finance and investments for sustainable development and facilitate the alignment of business operations with SDGs, the aggregated findings suggest:

- **Asset owners** must recognize their responsibilities of steering other actors towards "Long-termism." To this end, they should **consider adopting new contract terms, fee structures and performance benchmarks that reward long-term investing and responsible business practices.**
- **Asset managers** should prepare to distinguish themselves with strategies that will produce alpha returns for the least amount of risk while fostering optimal social and environmental positive impact. Additionally, they should **strive to raise the awareness of sustainable investing as a superior alternative to short-sighted gambling among their investors**.
- To incentivize long-term banking, **regulators should balance the need for systemic stability and access to long-term credits.** One plausible solution is to distinguish and adjust the risk weights for "green" and "brown" loans that better reflect the underlying risk characteristics of these two types of projects. Further, **policy makers should also consider adopting targeted dual interest rates** to lower the funding costs of sustainable investments if direct tax cuts to "green" projects aren't politically feasible.
- Non-financial companies should increase information disclosure regarding their progress on implementing policies that create long-term value with social and environmental impact. In addition, they should **carefully consider the composition of their boards and coordinate closely with the board members in crafting business strategies that embrace "Long-termism."**
- **Regulators should consider using various non-legal measures to encourage financial actors to invest in "Long-termism."** Such measures include but are not limited to setting guidelines to promote the convergence of financial and non-financial reporting standards, implementing a "Comply or Explain" policy to encourage information disclosures on

sustainability, and coordinating with regulatory bodies in other jurisdictions to create and adopt consistent reporting standards and terminology as well as a single, digitized regulatory access point.

- **For LDC's, credit or risk guarantee mechanisms can significantly reduce the uncertainty of investment returns and attract commercial investment in LDCs**. The guarantee can be sourced from the local government, strong advanced economies, and international organizations. Other risk mitigating tools can be pooled investment vehicles that manage risks within a diversified portfolio and achieve greater mobilization to scale up investments, such as contingent convertible bonds (COCO bonds).

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