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Regulatory Considerations for Sustainability-linked Derivatives

CONTENTS

EXECUTIVE SUMMARY

As individual and institutional investors increasingly invest in environmental, social and governance (ESG) activities, the role of derivatives to help meet ESG goals has grown.

One particular area of growth is sustainability-linked derivatives (SLDs), which have gained increasing prominence in the EU, UK and US. As market participants make greater use of these products to further their sustainability goals, it is important for the effectiveness and integrity of the SLD market to assess whether and how these nascent contracts fit into existing derivatives regulatory regimes.

This paper analyzes two categories of SLDs in the context of the regulatory frameworks established for derivatives in the EU, UK and US following the 2008 financial crisis. Specifically, this paper considers:

- Whether SLDs could be classified as swaps under US regulations and/or over-the-counter (OTC) derivatives under EU and/or UK regulations and, if so, what exemptions or exclusions might be available;
- The impact of sustainability-linked cashflows on derivatives that would otherwise be excluded or exempt from certain requirements under those regulatory regimes; and
- Compliance issues for market participants to consider if SLDs are classified as swaps and/or OTC derivatives contracts.

1. INTRODUCTION

Climate change and ESG issues have become increasingly prominent factors in financial markets and investments, and have therefore become an important area of focus for regulators. However, the extent of regulatory attention differs across jurisdictions, as does the approach of supervisors. Given the significance of this issue and the growth in ESG-related assets, it is important to ensure the regulatory framework both fosters ESG activity and ensures the safety of financial markets.

The EU is currently at the forefront of regulatory activity in this area. Recent initiatives include the 2018 Sustainable Finance Action Plan[1], the 2021 Strategy for Financing the Transition to a Sustainable Economy and the 2019 European Green Deal. Collectively, these have resulted in over 100 individual policy workstreams with the potential to affect the financial services industry directly or indirectly.

Regulatory developments have also occurred outside the EU. In the UK, the Bank of England has adopted a pioneering climate financial risk policy, while the government has established the 2019 Green Finance Strategy and the 2020 Green Industrial Revolution Plan and has invested in the Task Force for Nature-related Financial Disclosures. It also published *Greening Finance: A Roadmap to Sustainable Investing* on October 18, 2021, which sets out plans to ensure availability of appropriate information on sustainability to financial market decision-makers (among other things).

In the US, the Biden administration has shown a commitment to combatting climate change by reversing the US withdrawal from the Paris Climate Accords and issuing executive orders on climate change[2]. This has been matched by an increased focus from the Financial Stability Oversight Council and its constituent agencies, particularly the US Commodity Futures Trading Commission (CFTC)[3] and the Securities and Exchange Commission (SEC)[4], as well as US federal prudential regulators[5]. However, there has been less ESG-focused legislation or regulation to date than in the EU and UK[6].

[1] This was one of the first comprehensive policy strategies aimed at reorienting capital flows towards sustainable investments, managing environmental, social and governance (ESG)-related financial risks, fostering transparency and attenuating long-termism

[2] See Executive Order 14030: Climate-Related Financial Risk (May 20, 2021); Executive Order 14008: Tackling the Climate Crisis at Home and Abroad (January 27, 2021); Anthony Blinken, The United States Officially Rejoins the Paris Agreement, US Department of State (February 19, 2021), Other initiatives include a pledge to cut US greenhouse gas emissions in half by 2030, see President Biden Sets 2030 Greenhouse Gas Pollution Reduction Target Aimed at Creating Good-Paying Union Jobs and Securing US Leadership on Clean Energy Technologies, The White House Briefing Room (April 22, 2021), the appointment of John Kerry as the first Special Presidential Envoy for Climate and the creation of the White House Office of Domestic Climate Policy

[3] This includes the Climate Risk Subcommittee of the Commodity Futures Trading Commission's (CFTC) Market Risk Advisory Committee, Managing Climate Risk in the US Financial System (September 9, 2020)

[4] Examples of US Securities and Exchange Committee (SEC) action on climate risks include: (i) a solicitation of public comments on potential future changes to the SEC's climate-related risk disclosure regime, which prompted more than 400 comments; (ii) a risk alert from the SEC's Division of Examinations outlining the results of a review of ESG-related marketing and disclosure practices of investment advisors, registered investment companies and private funds offering ESG products and services; (iii) creation of a climate and ESG task force in the Division of Enforcement, which will work proactively to detect climate and ESG-related misconduct; and (iv) recently appointed chair Gary Gensler's announcement that SEC staff are developing a mandatory climate risk disclosure rule proposal for consideration by the end of 2021. See SEC Response to Climate and ESG Risks and Opportunities, www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities (last visited September 20, 2021); Gary Gensler, chair, SEC, Prepared Remarks Before the Principles for Responsible Investment Climate and Global Financial Markets Webinar (July 28, 2021). It remains to be seen how any future enforcement or rulemaking actions will approach the 'materiality' threshold for the imposition of SEC disclosure obligations. For example, see TSC Indus., Inc.v. Northway, Inc., 426 U.S. 438 (1976)

[5] Federal Reserve Board announces it has formally joined the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) as a member (December 15, 2020), www.federalreserve.gov/newsevents/pressreleases/bcreg20201215a.htm

[6] In response to Executive Order 14030, on October 21, 2021, the Financial Stability Oversight Council (FSOC) issued a report that, for the first time, identified climate change as "an emerging and increasing threat to US financial stability" and recommended actions for member agencies to take to identify and address climate-related risks. These recommendations are intended to assist agencies to: (i) assess climate-related financial stability risks and evaluate the need for new or revised regulations or guidance to account for such risks; (ii) enhance climate-related disclosures; and (iii) improve actionable climate-related data, among other things. See FSOC, Report on Climate-Related Financial Risk (October 21, 2021), https://home.treasury.gov/news/press-releases/jy0426

In parallel to these policy initiatives, there has been a rapid proliferation of ESG financial products, including ESG derivatives. ESG derivatives cover a broad spectrum of products, such as futures, swaps[7] and SLDs[8]. The latter are fast-emerging products that typically embed or create an ESG-linked cashflow as a component of, or by reference to, a conventional derivatives instrument using key performance indicators (KPIs) designed to measure compliance with ESG targets[9].

This paper sets out regulatory considerations for SLDs from an EU, UK and US perspective. The intention is to describe potential regulatory approaches to SLDs and to provide guidance to help market participants develop their own assessments[10].

Two distinct categories of SLDs are covered in this paper:

- The KPI(s) and the related impact on cashflow(s) are embedded within the derivatives transaction (a Category 1 SLD). An example of a Category 1 SLD could be a cross-currency interest rate swap (IRS) that provides additional payments, spread ratchets or a preferential exchange rate when the KPI is met[11]; and
- The KPIs and cashflows related to them are set out in a separate agreement that references underlying (generally vanilla) derivatives transactions for setting the reference amount to calculate the KPI-linked cashflow (a Category 2 SLD)[12]. The terms (including pricing) of the underlying transactions (which may include transactions with other affiliates of the parties) would generally not be affected. An example of a Category 2 SLD could be an agreement to make a payment if a counterparty meets its KPIs, with the payment calculated as a percentage of the notional amount of unrelated, separately documented derivatives transactions[13].

In the US, EU and UK, derivatives regulations will generally only apply to transactions that are classified as swaps or security-based swaps (SBS) in the US or derivatives in the EU and UK. A key question for any SLD is therefore whether it would be considered a swap/SBS or derivative under the relevant regulations.

[7] See ISDA, Research Paper: Overview of ESG-Related Derivatives Products and Transactions, www.isda.org/2021/01/11/overview-of-esg-related-derivatives-products-and-transactions/

[8] See ISDA, Sustainability-Linked Derivatives KPI Guidelines (September 2021), www.isda.org/2021/09/07/sustainability-linked-derivatives-kpi-guidelines?_zs=Ihqp81&_zl=ApOQ6 (SLD KPI Guidelines) at 1-4

[9] SLD KPI Guidelines at 4

[10] The discussions in this paper are not intended to be legal advice or definitive guidance and market participants should seek their own independent legal advice if required

[11] While it is unlikely a Category 1 SLDs would be out of scope for swaps or OTC derivatives regulation but for the KPI-linked cashflow, some of the analysis considered in Section 2 may be relevant

[12] There are likely to be other types of SLDs for which different regulatory issues may arise

[13] For example, a percentage of the net aggregate notional amount of all foreign exchange (FX) forward or FX swap transactions between the parties for the same currency pair

2. REGULATORY CONSIDERATIONS FOR SLDs – US ANALYSIS

Would a Category 1 SLD be Classified as a Swap Under US Regulations?

Assuming the derivative underlying a Category 1 SLD already falls within the definition of a swap, the inclusion of KPI-linked cashflows is unlikely to change this characterization. The instrument will therefore likely remain subject to all applicable US derivatives regulations.

For example, if the parties enter into an IRS, an increase or decrease in the spread would not cause the transaction to stop being regulated as a swap for US regulatory purposes. However, the addition of the KPI-related cashflows may give rise to other regulatory issues. For instance, parties will need to consider whether valuation and margin models are appropriately calibrated for the additional cashflow(s), adequate disclosure is made to counterparties and the approach to internal risk management satisfies regulatory requirements.

Accounting issues and bankruptcy laws also need to be considered. For example, the KPI-linked cashflow may not be covered by legal opinions and may impact the availability of hedge accounting, which may need to be disclosed to swap counterparties.

One additional characterization question is whether the KPI-linked payment term would transform what would otherwise be a SBS into a mixed swap[14]. In practice, there are so far insufficient volumes of equity- or credit-related SLDs to identify trends for these products.

Could a Category 1 SLD Fall Within the Hedging Exceptions Under US Derivatives Regulation?

US derivatives regulation provides exceptions from clearing, on-platform trade execution and margin requirements for swaps involving certain market participants that are not predominantly financial in nature and "us[e] swaps to hedge or mitigate commercial risk"[15].

For example, parties to a cross-currency IRS may need to consider whether the non-financial counterparty is still deemed to be using a swap "to hedge or mitigate commercial risk" if it has access to a spread ratchet, more favorable exchange rate or a separate payment if it meets its KPI target.

[14] The term 'mixed swap' refers to a security-based swap that also is based on the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (with certain exceptions). 7 USC 1a(47)

[15] The CFTC's margin requirements for swap dealers for non-cleared swaps also do not apply to counterparties that are not: (i) another swap dealer; or (ii) a financial end user as defined under 17 CFR 23.151. Therefore, even if a non-swap dealer counterparty's activities are financial in nature, it would not be in scope of margin requirements unless it also falls within the list of enumerated types of financial end users

Although SLDs are generally not used as hedging instruments, the distinguishing feature of a Category 1 SLD is that the KPIs create or impact cashflows within conventional or vanilla derivatives, which may themselves have been used for hedging purposes[16]. In this situation, the objective of the overall transaction will likely remain the hedging of the original risk[17] and will not switch to hedge the KPI-linked risk. For instance, it is unlikely the transaction would be used by either party primarily to hedge the KPI-linked risk accepted through a sustainability-linked loan or bond[18].

In the absence of unusual payment structures, it may be reasonable to conclude that the swap continues to satisfy the exception's requirement that it is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise" arising from the relevant exposure[19].

Accordingly, counterparties seeking to ensure that a Category 1 SLD retains eligibility for hedging exemptions may want to make clear that the addition of the KPI-linked payment terms is not for speculative, investment or other trading purposes, but is instead intended to enhance the sustainability of the non-financial entity's operations[20].

Statements to this effect in the SLD documentation may be helpful, but it will be critical to bolster this conclusion by selecting meaningful, ambitious KPI targets for the SLD.

Would a Category 2 SLD be Classified as a Swap under US Regulations?

The question of whether a Category 2 SLD or any referenced transactions that are otherwise out of scope would be brought within the ambit of the US swaps regulatory regime is more complex. Under the US regulatory framework, a swap includes, among other things, any agreement, contract or transaction[21] that:

- Is an option for the purchase or sale of, or based on the value of, a commodity (broadly defined to include almost any asset or quantitative measure);
- Provides for any purchase, sale, payment or delivery dependent on the occurrence (or otherwise) of an event or contingency associated with potential financial, economic or commercial consequences; or
- Provides for the exchange of payment(s) based on the value or level of one or more commodities (broadly defined as above), while simultaneously providing for a transfer of the financial risk associated with a future change in the value or level (but not of any ownership in or liabilities associated with the corresponding underlying assets)[22].

16 SLD KPI Guidelines at pages 4 and 5

17 For example, FX, interest rate or other price (or similar) risk

18 Based on particular circumstances of each transaction, parties should independently consider whether the addition of the KPI-linked payment features may disqualify the transaction from any otherwise applicable regulatory exception or exemption for hedging under US derivatives regulation or impact that party's classification as a matter of EU or UK law

19 See 17 CFR 50.50(c) (defining when a swap is used to "hedge or mitigate commercial risk" under Section 2(h)(7)). A similar analysis may apply with respect to exemptions from position limits. The CFTC has, for the first time, imposed position limits, to enter into force in 2023, on swaps that are economically equivalent to futures contracts subject to such limits. These limits do not apply to a bona fide hedging position. The bona fide hedging exemption is defined in a manner similar to the exception under 17 CFR 50.50 but is narrower in that it also requires that the position "represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel". 17 CFR 150.1

20 The availability of hedging exemptions is more relevant to Category 1 SLDs because, as noted, a Category 1 SLD is more likely to fall within the swap definition and therefore require regulatory exceptions or exemptions. If an SLD is used for hedging, it may not fit within the CFTC and SEC's commercial agreements carve out from the swap definition because it would be entered into for a "speculative, hedging or investment" purpose

21 The Wall Street Transparency and Accountability Act of 2010

22 The term 'security-based swap' is defined as a swap that has additional enumerated characteristics (eg, it is based on a single security or loan or a narrow-based security index). Therefore, except where otherwise stated, references to swaps in this paper may also include security-based swaps

As would be expected, the mere label used to refer to a particular agreement, contract or transaction will not determine whether that instrument is considered a swap. Instead, regulatory guidance focuses on the terms and characteristics of an instrument. The following paragraphs set out some of issues market participants are considering when determining whether Category 2 SLDs would be deemed swaps for US regulatory purposes[23].

For the first prong of the swap definition – whether a Category 2 SLD would qualify as an option based on the value of one or more quantitative measures: At a high level, this does not necessarily appear to be the case. An option would ordinarily involve the option buyer paying a premium to the option seller for the right but not the obligation to buy or sell an asset. In a typical Category 2 SLD, a KPI-linked payment is not considered a premium in the sense of an option contract, as the payment is not made in exchange for any rights with respect to an underlying asset. Rather, it is paid by one party based on the achievement of ESG targets that are evaluated against established KPIs. Even if satisfaction of the KPI target is considered an underlying asset, the amount of any KPI-linked payment is not related to any associated value (nor, in fact, is any such value assigned)[24].

Instead, payments under a Category 2 SLD are often calculated as a percentage or function of the total notional amount of a set of identified underlying transactions, which are typically unrelated to the parties' sustainability efforts. The promise of increased notional amounts of transactions between parties based on KPI targets is unlikely to be considered a form of premium, as any potential cashflow paid under a Category 2 SLD would seem insufficient to entice a counterparty to enter into additional transactions. The increased notional amount therefore does not appear to reflect the value of the option.

For the second prong of the swap definition – whether a Category 2 SLD provides for any purchase, sale, payment or delivery associated with the occurrence of an event: A payment under a Category 2 SLD is typically linked to whether the sustainability-linked KPI target has been met. As a result, the question is whether this event can be said to be associated with a potential financial, economic or commercial consequence[25].

Currently at least, meeting (or failing to meet) the sustainability-linked KPI target may not have financial, economic or commercial consequences for the counterparties. Parties generally do not enter into Category 2 SLDs with a view to hedge or insure against losses that may be incurred as a result of failing to meet the KPI target. This is because the cashflow is only payable to a party if it meets the target and, in some cases, the payment may ultimately be made to a charity rather than the counterparty. The stated purpose is pursuit of sustainability goals rather than hedging, speculation or investment by either party. As such, neither party appears to be taking a speculative position as both parties expect the same outcome.

[23] According to CFTC regulatory guidance, the use or absence of industry-standard swap documentation is a relevant but not conclusive factor. See CFTC and SEC, Final Rule, Further Definition of 'Swap' and 'Security-Based Swap', 77 Fed Reg. 48208, 48260 (August 13, 2012) (products rule)

[24] In a traditional option, the price of a premium ordinarily reflects the difference between the option strike price and the spot price at execution plus the time value of the option based on expected changes in the value of the underlying asset before maturity

[25] There is little guidance on the meaning of this phrase, although the CFTC and SEC have indicated that insurance products could fall within scope were it not for a specific safe harbor. See products rule at 48212 ("Accordingly, the Commissions believe that state or Federally regulated insurance products that are provided by persons that are subject to state or Federal insurance supervision, that otherwise could fall within the definitions should not be considered swaps or security-based swaps so long as they satisfy the requirements of the Insurance Safe Harbor")

For the third prong of the definition of a swap – whether an agreement provides for an exchange of payments: Although a Category 2 SLD may arguably provide for the exchange, on a contingent basis, of a payment based on the value or level of a quantitative measure (the quantitative measure being the agreed KPI), these contracts would not transfer the financial risk associated with a future change in the KPI level. This is because, as noted above, entry into the Category 2 SLD is unlikely to be characterized as hedging or insuring against a failure to meet the KPI target. Instead, the size of the rebate is often modest compared to the size of the parties, and the motive for entry is primarily the pursuit of sustainability goals.

On this basis, it appears unlikely that a Category 2 SLD would be considered a swap under the US regulatory definition.

Category 2 SLDs could be considered contracts for difference (CFD) and therefore may fall within the scope of the swap or SBS definition according to CFTC and SEC guidance[26]. The commissions state that a CFD is generally an agreement to exchange the difference in value of an underlying asset between the time at which a CFD position is established and the time it is terminated. If the value increases, the seller pays the buyer the difference; if the value decreases, the buyer pays the seller the difference. Depending on the structure of the SLD (ie, whether KPI-linked payments go in one direction or two), it could fall within the definition of a CFD.

Could a Category 2 SLD be Considered a Commercial Agreement Outside US Swaps Regulation?

US regulators have noted that certain types of commercial transactions involving customary business arrangements should not be considered swaps, although they may technically fall within the text of the swap definition. To this end, the CFTC and SEC have listed certain types of transactions involving customary business arrangements that are not considered swaps[27]. This list was never intended to be exhaustive and was designed to accommodate novel types of transactions subsequently developed based on their particular facts and circumstances. Accordingly, the fact SLDs are not included in this list is not fatal to the analysis given SLDs were only developed seven years after the guidance was issued.

The CFTC and SEC have indicated that, in order to qualify for a commercial agreement exemption, agreements or transactions should:

- Not contain severable payment obligations;
- Not be traded OTC or on an organized market;
- Be entered into by commercial or non-profit entities to serve an independent commercial, business or non-profit purpose; and/or
- Not be entered into for speculative, hedging or investment purposes[28].

[26] See products rule at 48260

[27] Such commercial agreements expressly enumerated in the products rule are: (1) employment contracts and retirement benefit arrangements; (2) sales, servicing or distribution arrangements; (3) agreements for the purpose of effecting a business combination transaction; (4) the purchase, sale, lease or transfer of real property, intellectual property, equipment or inventory; (5) warehouse lending arrangements in connection with a securitization of assets; (6) mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables; (7) fixed or variable interest rate commercial loans or mortgages entered into by banks and non-banks (including but not limited to loans or mortgages with embedded interest rate locks, caps or floors, provided such loans or mortgages do not have "additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed"; and (8) commercial agreements (including but not limited to leases, service contracts and employment agreements) containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index. Products rule at 48247

[28] See products rule at 48248

Applying this framework to Category 2 SLDs results in the following considerations.

Severable payment obligations: Most Category 2 SLDs so far do not contain payment terms that are severable from the KPI-linked agreement. On the contrary, the payment terms generally form the crux of the agreement.

For example, under a typical Category 2 SLD, a financial institution will agree to make certain payments to its commercial counterparty if, by a set deadline, the counterparty has satisfied one or more ESG-linked KPI targets established by the parties at the time of contracting. If the commercial counterparty fails to satisfy the KPI(s), it will receive no payment and, in certain cases, must make a payment to the financial institution counterparty.

The premise of the agreement is that the conditional promise of such payment(s) incentivizes the commercial counterparty to make progress toward its ESG objectives. To the extent the payment obligation is severed from the agreement, the purpose of the agreement would be frustrated. Moreover, Category 2 SLDs (including payment terms) are generally not assignable or are assignable only with the prior written consent of the other party.

Trading on an organized market or OTC: Category 2 SLDs are generally negotiated individually to reflect the unique business model, operations and sustainability objectives of the commercial counterparty, and are not traded on an organized market or OTC.

Commercial participants and purposes: To the extent one party to the transaction is a commercial or non-profit entity, it may be possible to satisfy the requirement on type of entity even when the other party is a bank or similar financial institution. A Category 2 SLD may therefore be considered a commercial agreement that is not in scope for US swaps regulation. This is because several examples set out in the guidelines of commercial agreements not treated as swaps involve a commercial bank as a party.

Generally, the purpose of Category 2 SLDs is to support a commercial counterparty's progress toward ESG goals by providing an incentive to achieve these goals. As a practical matter, it may be helpful to demonstrate this purpose by ensuring the selected KPIs reflect significant sustainability progress and the KPI-linked payments provide a meaningful incentive for such progress.

Speculative, hedging or in investment purposes: In the current market, and in the context of KPIs that have no market price or direct material impact on share prices, it is unlikely Category 2 SLDs will be considered to have been entered into for speculative, hedging or investment purposes. The parties are not speculating because both expect the same outcome – that is, for the commercial counterparty to meet its ESG targets in line with the incentives provided by the KPIs.

Category 2 SLDs may not be effective to hedge any risks[29] associated with a failure to meet the selected KPIs. This is because, in the event of such a failure, the party would not receive the KPI-linked payment and may be required to make a payment for the same amount.

In addition, Category 2 SLDs are generally not entered into for investment purposes. To the extent a Category 2 SLD represents a potentially income-producing asset for a commercial counterparty, this may be seen as a result of that counterparty's own sustainability-related actions with respect to its business, as opposed to the efforts of any third party[30].

[29] For example, in terms of share price, reputational or regulatory risk

[30] For example, see SEC v. W. J. Howey Co., 328 US 293 (1946) (defining an expectation of profit from the 'efforts of others' as a necessary element of an 'investment contract' under the Securities Act of 1933)

The KPI-linked cashflow may also be donated to a charity selected by the parties (although this is not required). The inclusion of such a provision could further support the view that the Category 2 SLD is not entered into for investment, speculative or hedging purposes. It may therefore be considered a commercial agreement outside the scope of US swaps regulation given neither party would retain a direct monetary benefit from the Category 2 SLD in these circumstances[31].

Importantly, an SLD's eligibility for status as a commercial agreement will be specific to the facts and circumstances of each case and may change over time based on market developments[32].

[31] The CFTC and SEC have made it clear that the factors discussed in this section are not intended to be a bright-line test and the presence or absence of a particular characteristic or factor should not be seen to imply that Category 2 SLDs would automatically fall under the commercial exemption. Instead, an SLD's eligibility for this exclusion will be specific to the facts and circumstances of each case and may change over time based on market developments, and certain Category 2 SLDs may potentially be categorized as commercial agreements based on this analysis. As liquidity and standardization develops, and particularly as independent pricing related to KPI compliance and/or materiality of KPI compliance for share prices or similar factors develops, the outcome of the analysis may be affected

[32] Notably, certain Category 2 SLDs may potentially be categorized as commercial agreements based on this analysis

3. REGULATORY CONSIDERATIONS FOR SLDs – EU AND UK ANALYSIS[33]

Would a Category 1 SLD be Classified as a Derivative Under EU and/or UK Law?

With a Category 1 SLD, it is likely that the instrument itself (ie, independent of the KPI elements) could already be classified as a derivative under EU and/or UK law. Where this is the case, embedding additional KPI elements is unlikely to change the fundamental nature of the rights and obligations, meaning the transaction would probably remain a derivative. In these circumstances, the nature and extent of the amendments arising from the KPIs (which will vary from case to case) might give rise to questions over which category of derivative (and, by extension, financial instrument) the transaction might fall into, as well as the related regulatory and compliance obligations that might follow.

Would a Category 2 SLD be Classified as a Derivative Under EU Law?

Under EU law, a derivative is defined by reference to a subset of financial instruments listed in the revised Markets in Financial Instruments Directive (MIFID II), the EU legislation determining (among other things) when market participants dealing in derivatives need to be regulated. Broadly, this encompasses:

- Options, futures, swaps, forwards and other derivatives contracts where the underlying is a financial instrument, currency, rate, emission allowance, other derivative or index, whether physically settled or cash settled;
- Options, futures, swaps, forwards and other derivatives contracts where the underlying is a commodity if settled in cash or where it is physically settled in specific circumstances set out in the relevant rules;
- Credit derivatives;
- Financial CFDs; and
- Other cash-settled derivative contracts relating to climatic variables, among other things.

Category 2 SLDs are unlikely to fall within the majority of the financial instruments under EU law. This is because the payout on a Category 2 SLD does not directly relate to financial instruments, currencies, rates, emission allowances (assuming it is not also a carbon derivative), other derivatives, indices or commodities, or involve a transfer of credit risk or a financial CFD[34].

[33] The revised Markets in Financial Instruments Directive (MIFID II) will be amended in 2022 to introduce sustainability factors, which will be embedded into certain MIFID obligations (in particular, with respect to suitability for investment advice and portfolio management, as well as product governance for manufacturers and distributors). This section is focused on product characterization only and, accordingly, does not seek to address the wider conduct and prudential issues that may come into play

[34] The specific UK definition of contracts for differences may be different. The Addendum Consultation Paper published by the European Securities and Markets Authority (ESMA) prior to MIFID II coming into effect (www.esma.europa.eu/sites/default/files/library/2015/11/2015-319_cp_addendum_mifid_ii-mifir.pdf) defines a financial contract for differences as "a derivative product that gives the holder an economic exposure, which can be long or short, to the difference between the price of an underlying asset at the start of the contract and the price when the contract is closed". An SLD would not give counterparties to it an exposure to the difference of any price as such

However, MIFID II also contains a broad catch-all provision that brings any other derivatives relating to assets, rights, obligations, indices and measures not otherwise mentioned in the relevant list that have the necessary characteristics of other financial instruments into scope of derivatives regulation.

It could therefore be possible for an SLD to fall within the MIFID II catch-all of 'other derivatives contracts'[35]. This would mean that, even if an SLD is not classified as an option, future, swap or forward rate agreement (which would typically be the case), it could nevertheless be regulated as a derivative. Indeed, notwithstanding the lack of guidance on the meaning of 'other derivatives contracts', an SLD could be considered a derivative in the non-technical sense of being a contract with a value derived from an independent factor that is not directly tied to the performance of the contract.

Additional EU rules specify in more detail which instruments are covered by this catch-all provision[36]. In accordance with these rules, a derivative will fall within this provision if it fulfils both of the following conditions: (i) the derivatives contract is settled in cash; and (ii) it relates to at least one of a list of applicable underlyings[37]. This includes allowances, credits, permits, rights or similar assets directly linked to the supply, distribution or consumption of energy derived from renewable resources, a geological, environmental or other physical variable, any asset or right of a fungible nature (other than a right to receive a service) that is capable of being transferred, and an index or measure related to the price, value or volume of transactions in any asset, right, service or obligation[38].

Whether these factors apply would depend on the precise details of the KPI. For example, where the KPI relates to an increased volume of renewable energy used by one of the counterparties, there would be a measure of whether there was an increased volume of transactions in an asset and the payout under the SLD would depend on such a measure. In this example, the SLD could be categorized as a derivative under applicable EU regulation, as it would be settled in cash and would include a volume-related measure that affects the payout.

Notwithstanding the lack of detailed EU regulatory guidance on the scope of the catch-all provision[39], it is expected that at least some Category 2 SLDs could fall within scope and be considered derivatives for EU regulatory purposes.

[35] See Section C(10) of Annex I of MIFID II

[36] This regulatory guidance is provided in Article 8 of the delegated regulation

[37] As set out in Article 8 of the delegated regulation

[38] As set out in Article 7(3) of the delegated regulation

[39] The precise scope may vary between member states given the implementation of MIFID II into national law and, by extension, the potential for different views to be taken. Different EU member state regulators may also have produced more specific guidance

Would a Category 2 SLD be Classified as a Derivative Under UK Law?

As a general matter, a derivative under EU law will also be a derivative under UK law following Brexit[40]. UK law also includes additional definitions of specific types of derivatives – namely, options[41], futures[42] and CFDs[43]. To the extent they have a wider scope than the EU definitions, UK regulators will apply its definitions when considering how to classify a Category 2 SLD.

A Category 2 SLD is unlikely to be classified as an option, as it does not generally give counterparties the choice to acquire or dispose of anything (as required by the applicable UK definition of an option). Likewise, a Category 2 SLD is unlikely to qualify as a future given it would not be considered a contract for the sale of any property as required by the applicable UK definition of a future.

A Category 2 SLD could in principle be a CFD under UK law. The term captures three relevant types of contracts: two are coextensive with the EU law definitions, but one is wider in scope.

The definition of the wider scope category is a "contract the purpose or pretended purpose of which is to secure a profit or avoid a loss in relation to fluctuations in the value or price of property of any description; or an index or other factor designated for that purpose in the applicable contract"[44].

UK regulatory guidance[45] states that 'other factors' in the catch-all provision include a wide range of elements, including measures that typically constitute a KPI. A Category 2 SLD could therefore fall within the definition of a CFD under UK law if its purpose is to allow a counterparty to avoid a loss or secure a profit by reference to fluctuations in the KPI.

Under a typical SLD, the payout is binary. In other words, the exact value of a KPI at any given time may have no impact in determining whether payment should be made, as long as the KPI is higher than a target. This means any fluctuations in the value of a KPI (ie, whether the value goes up or down as opposed to whether it is higher or lower than the target) would not itself determine whether payment should be made.

If this is the case, then the SLD would not be caught by this definition. However, if the payouts under an SLD vary based on fluctuations in one or more KPIs, then it would likely fall within the definition. Where the relevant KPI is not covered by the 'other derivatives contracts' definition under EU law – for example, a variable green rating from an external party – it is possible the SLD could fall within the scope of UK regulation but outside of EU regulation.

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[40] In the context of Brexit, the UK onshored the majority of EU legislation applicable to the UK before Brexit into domestic law (where it was not already part of UK law). As such, Section C of Annex I of MIFID II is substantively replicated in Part 1 of Schedule 2 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) and the delegated regulation has been incorporated largely unamended into UK law by virtue of the UK European Union (Withdrawal) Act 2018, as amended (EUWA)

[41] Subject to certain exemptions, options are defined in Article 83(1) of the RAO as "Options to acquire or dispose of: (a) a security or contractually based investment (other than one of a kind specified by this article); (b) currency of the United Kingdom or any other country or territory; (c) palladium, platinum, gold or silver; or (d) an option to acquire or dispose of an investment of the kind specified by this article by virtue of paragraph (a), (b) or (c)"

[42] Subject to certain exemptions, futures are defined in Article 84(1) of the RAO as "rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made"

[43] A contract for differences is defined (in general terms) in Article 85(1) of the RAO as "(a) a contract for differences; or (b) any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in: (i) the value or price of property of any description; or (ii) an index or other factor designated for that purpose in the contract"

[44] Article 85(2) of the RAO sets out exemptions – most notably, that the profit is secured or loss avoided by one or more of the parties taking delivery of property to which the contract relates. However, these exceptions would not typically apply to a Category 2 SLD

[45] UK Financial Conduct Authority Perimeter Guidance (PERG), para. 2.6.23

Hedging-related Issues Relating to the Non-financial Counterparty Threshold

For the purposes of establishing which obligations under the European Market Infrastructure Regulation (EMIR) and UK EMIR[46] apply to counterparties entering into derivatives contracts, the regulations classify such counterparties by reference to thresholds, known as the clearing thresholds. The clearing thresholds measure the gross notional value of OTC derivatives contracts entered into by that counterparty and applicable members of its group over the relevant time period.

When calculating these clearing thresholds, counterparties other than financial entities[47] are permitted to exclude any contracts that qualify as hedging contracts from their calculations. To qualify as a hedging contract, an OTC derivatives trade is required to be objectively measurable as reducing the risks directly related to the commercial or treasury financing activities of either the non-financial counterparty or other non-financial counterparties within its wider group[48].

Where the non-financial counterparty falls below the relevant clearing thresholds[49], it will not be required to clear or margin its OTC derivatives contracts, although it will be subject to certain other obligations under EMIR, such as the timely confirmation, portfolio reconciliation, portfolio compression and dispute resolution obligations.

In the case of a Category 1 SLD where the original instrument is used for hedging purposes, non-financial counterparties should consider whether that instrument continues to satisfy the relevant criteria following the inclusion of the KPIs.

It is important to note that the requirement is only for the OTC derivatives contract to continue to be objectively measurable as reducing the relevant risks – there is no need for this to be the sole purpose of the derivatives contract.

In the absence of unusual KPI related cashflows or changes to the hedging structure, it may therefore be reasonable to conclude that the OTC derivatives contract can continue to be objectively measurable as reducing the relevant risks and qualify as a hedging contract for these purposes.

[46] Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories, as amended from time to time (the European Market Infrastructure Regulation (EMIR)) or EU EMIR as it forms part of retained EU law as defined in the European Union (Withdrawal) Act 2018 (as that act is amended from time to time, the Withdrawal Act) (UK EMIR), as applicable

[47] Non-financial counterparties are defined in Article 2(9) of EU EMIR or UK EMIR (as applicable) and encompass entities other than investment firms, credit institutions and certain regulated insurance or reinsurance undertakings, UCITS, institutions for occupational retirement provisions, alternative investment funds and central securities depositories

[48] Article 10 of the risk mitigation regulatory technical standard (RTS) (or its UK equivalent) specifies that an OTC derivatives contract will be objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or relevant group members when, by itself or in combination with other derivatives contracts, directly or through closely correlated instruments, it meets one of the following criteria: (i) it covers the risks arising from the potential change in the value of assets, services, inputs, products, commodities or liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business; (ii) it covers the risks arising from the potential indirect impact on the value of assets, services, inputs, products, commodities or liabilities referred to in (i) resulting from fluctuation of interest rates, inflation rates, foreign exchange rates or credit risk; or (iii) it qualifies as a hedging contract pursuant to International Financial Reporting Standards

[49] Such a counterparty is referred to as a non-financial counterparty minus (NFC-) for the purposes of UK EMIR and EU EMIR

In the case of a Category 2 SLD, as previously stated, counterparties do not generally enter into these contracts for hedging purposes. Instead, they are more commonly entered into to meet specific sustainability goals. It is relevant to note that: (i) the cashflows under a Category 2 SLD are only payable to a party if it meets its target (and, where the party fails to do so, it may instead be required to make a payment); and (ii) in some cases, the payment may ultimately be made to a charity rather than the counterparty itself.

In light of this, it may be unlikely that a Category 2 SLD would satisfy the criteria required for it to be considered a hedging contract for the purposes of a non-financial counterparty's clearing threshold calculations. Entities should nonetheless consider each transaction on its particular facts.

4. IMPACT ON UNDERLYING DERIVATIVES OF CATEGORY 2 SLDs CLASSIFIED AS SWAPS

US Analysis

As noted in previous sections, the amount of the KPI-linked payment(s) for Category 2 SLDs is often tied to the notional amount of separate, unrelated derivatives transactions (eg, plain vanilla derivatives) between the counterparties and, in some cases, their affiliates.

Counterparties will need to determine whether structuring a Category 2 SLD to reference the notional amounts of these underlying transactions may affect the classification of the underlying transactions. This is especially important if the underlying transactions are otherwise eligible for a regulatory exemption, as in the case of exempted physically settled foreign exchange (FX) forwards and FX swaps in the context of the US regulatory regime[50].

Importantly, the exemption requires physically settled FX forwards and swaps to solely involve the exchange(s) of currencies listed in the definition. In this situation, market participants may wish to consider whether entering into a Category 2 SLD with payments calculated on the basis of the notional amounts of these underlying transactions (eg, an FX swap or FX forward transaction) can potentially disqualify the parties from claiming the relevant exemption[51].

While dependent on the relevant facts and circumstances, there may be a stronger basis for arguing that the Category 2 SLD can be disaggregated from the underlying transactions and should not impact their characterization if the pricing, mark-to-market value or risk profile of the underlying FX swaps and forwards and the Category 2 SLD are documented and booked separately from such underlying transactions. The analysis may be further strengthened if the Category 2 SLD is not linked to any FX risk or the performance or non-performance of the underlying transactions by either party.

Even if it is not possible to disaggregate the Category 2 SLD from the underlying transaction, CFTC and SEC guidance in the context of physically settled forwards with embedded optionality may, by analogy, be helpful[52]. US regulatory guidance confirms that transactions with embedded volumetric optionality may satisfy the forward exclusions from the swap and future delivery definitions under certain circumstances[53]. The guidance covers forwards with embedded volumetric optionality, optionality in the form of evergreen and renewal provisions and optionality with respect to delivery points and delivery dates.

[50] US Department of the Treasury, Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act (CEA), 77 Fed. Reg. 69694 (November 20, 2012). FX forwards and FX swaps are exempt from most but not all swap regulatory requirements under the CEA

[51] A foreign exchange forward is defined in Section 1a(24) of the CEA as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange". A foreign exchange swap is defined in Section 1a(25) of the CEA as "a transaction that solely involves: (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange"

[52] The discussion of forwards with embedded volumetric optionality, optionality in the form of evergreen and renewal provisions and optionality with respect to delivery points and delivery dates only relates to physically settled forwards between two commercial parties

[53] A similar issue arises in the context of carbon derivatives. The CFTC has previously confirmed that environmental commodities such as carbon credits may qualify as non-financial commodities for this purpose. In the products rule, it confirmed that the application of the forward exclusion is a facts-and-circumstances analysis, but the parties' intent to make and take delivery is a key factor in this analysis. As new counterparties join the carbon markets and new structures develop – including where there is a possibility the transaction may be rolled or cash settled or may have embedded optionality – market participants may need to retest their analysis on whether delivery is intended at the time of contracting. For example, they may wish to consider whether counterparties are able to make or take delivery of the credits (eg, whether they are onboarded with relevant carbon credit registries)

The CFTC and SEC interpret forward contracts that contain an embedded commodity option or option to be excluded as non-financial commodity forward contracts (and not swaps) if the embedded option(s): (i) may be used to adjust the forward contract price but do not undermine the overall nature of the contract as a forward contract; (ii) do not target the delivery term so the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which it is embedded.

Applying the same logic to SLDs, the presence of conditionality or optionality may not be viewed as necessarily recharacterizing an otherwise out of scope product if the KPI-linked features do not undermine the overall nature of the contract as a physically settled swap or forward and do not target the predominant feature of the contract (the actual physical exchange of currency).

Moreover, while a Category 2 SLD is separate from the underlying transactions, it could not be marketed separately without reference to these transactions in a secondary market, as the amount of the KPI-linked payment(s) is generally calculated as a function of the notional amounts of the underlying transactions between the original parties to the SLD[54].

EU and UK Analysis

Similar issues do not arise in the EU and UK. The potential characterization of a Category 2 SLD as a derivative would not affect any underlying transactions because, under EU and UK law, a Category 2 SLD would be assessed distinctly from any other related derivatives. Classification of one should therefore not affect the other or result in them being characterized as a single instrument[55].

[54] The CFTC and SEC may recharacterize a transaction as a swap if it has been willfully structured to evade the applicable regulation.17 CFR 1.3 (subsection (6) of swap definition) ("An agreement, contract, or transaction that is willfully structured to evade any provision of Subtitle A of [Title VII], including any amendments made to the [CEA] thereby (Subtitle A), shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the [CFTC] promulgated thereunder")

[55] Assuming the SLD does not directly amend the terms of those derivatives and the operation of those derivatives is unchanged following entry into the related SLD

5. COMPLIANCE ISSUES IF CATEGORY 1 AND 2 SLDS ARE CONSIDERED SWAPS

Regulatory requirements under US, EU and UK law may apply to both Category 1 SLDs – where counterparties will need to determine how to comply with existing regulations relating to the unique KPI-linked features of the otherwise vanilla transaction – and Category 2 SLDs that are deemed to be a swap or OTC derivative.

This section analyzes the main issues that are likely to be relevant in all three regimes – although the precise requirements of each regime would ultimately need to be considered. Given the intention of US, EU and UK regulators to impose broadly consistent frameworks where possible, in line with recommendations by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO), compliance approaches should be similar across jurisdictions.

Certain Risk Management and Documentation Requirements

US, EU and UK law generally require certain regulated firms (eg, investment firms in the EU and UK and swap dealers in the US) to have effective procedures for risk management, which would include procedures for managing risks associated with SLDs. Most participants in these markets would likely already be regulated entities subject to these requirements. In general, these firms would need to identify any particular risks associated with the KPI-linked cashflows[56].

Where an SLD has been classified as an OTC derivatives contract in the EU/UK[57] or as a swap in the US, certain transaction-specific obligations may apply, including: (i) confirmation-related requirements; (ii) portfolio reconciliation; (iii) dispute resolution; (iv) portfolio compression; and (v) exchange or posting of margin for in-scope non-cleared derivatives.

Compliance with the portfolio reconciliation, dispute resolution and portfolio compression obligations should not be an issue, as regulatory requirements are imposed at a portfolio level rather than the level of the individual transaction. Equally, the confirmation-related obligations should not be problematic, as they are intended to ensure transactions are documented in a timely manner (ie, within a certain time period), which would not impact the contents of the documentation in question. Accordingly, it is likely that counterparties may continue to comply with these obligations in the usual way, although operationally challenging updates to templates may be required.

Market participants will, however, need to consider if and how KPI-linked cashflows should be modeled for the various valuation obligations that apply to swaps and OTC derivatives. For example, initial margin models are required to capture all of the material risks that affect non-cleared swaps or OTC derivatives contracts, meaning ISDA may at some point need to calibrate its Standard Initial Margin Model to accurately capture KPI-linked risks, or determine that those are not risks that would need to be captured.

[56] SLDs may be unlikely to alter a swap dealer's risk profile materially, as the KPI-linked payments that have emerged to date have generally been small relative to the size of the parties' overall swap trading relationship. However, SLDs may require a somewhat different pricing methodology given the contingent nature of the KPI-linked payment obligations (linked to the actions of the contingent payee), as well as the bespoke nature of the agreements and lack of an existing market for price benchmarking

[57] As contained in Article 11 of EU EMIR and associated secondary legislation (Commission Delegated Regulation (EU) No 149/2013 of December 19, 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties and risk mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, as amended from time to time (the risk mitigation RTS) and Commission Delegated Regulation (EU) 2016/2251 of October 4, 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, as amended from time to time (the margin RTS)) for the purposes of EU law or as contained in Article 11 of UK EMIR and associated secondary legislation (the risk mitigation RTS and the margin RTS) as each form part of retained EU law as defined in the Withdrawal Act (as applicable). See also 17 CFR Part 23, Subpart J

Reporting

If SLDs are characterized as swaps or OTC derivatives, there is a requirement to report them to a swap data repository (SDR) in the US or a trade repository in the EU/UK, absent an exemption[58]. This raises the question of how to report the relatively novel KPI-linked features of the transaction given the existence of prescriptive reporting frameworks that were not designed with SLDs in mind and therefore do not necessarily have the capacity to reflect the unique aspects of these trades.

Two distinct issues arise under the US framework. First, while there is currently a catch-all reporting field, this is set to be removed in May 2022 following amendments to the CFTC reporting rules. Counterparties will need to establish (with regulators if necessary) how best to report in future[59]. Counterparties may also need to work with SDRs to establish how to provide the internal product identifier or product description used for this emerging and relatively heterogeneous transaction type.

In the EU and UK, none of the 129 reporting fields mandated by the applicable secondary legislation relate to KPIs or SLDs, either directly or indirectly. The possible exception is Field 17 of Table 1 (value of contract), which relates to the mark-to-market or mark-to-model valuation of the derivatives contract in question.

Disclosure

Market participants will also need to be aware of the various disclosure requirements that may apply to their SLDs under EU, UK and US regulation.

Currently, these requirements are most extensive and developed in the EU, where a package of reforms relating to sustainable finance[60] has introduced numerous disclosure-related requirements directly affecting ESG-related products. Of particular relevance are the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation.

The SFDR imposes transparency and sustainability-related disclosure requirements for financial market participants and financial advisors on their financial products (as these terms are defined by the SFDR). While the SFDR does not directly regulate derivatives (as they do not meet the definition of financial product as an explicitly named class of product), its requirements may nevertheless have direct relevance to SLDs (and derivatives more generally). This is because the definition of financial product captures products that may include derivatives.

For example, the definition of financial product includes any portfolio managed in accordance with mandates given by clients on a discretionary client-by-client basis, where the portfolios include one or more financial instruments. This includes commodity derivatives and derivatives for the transfer of credit risk (among a range of other forms of financial instrument). As a result of this financial product definition, it is also established that investment firms and credit institutions that provide portfolio management are classifiable as financial market participants for the purposes of the SFDR.

[58] This obligation arises in the US under the CFTC's Part 43 real-time public reporting requirements and Part 45 swap data reporting (SDR) reporting requirements. In the EU, this obligation arises under Article 9 of EU EMIR. In the UK, it arises under Article 9 of UK EMIR

[59] The 'other payment' fields included in the new Part 45 may be one avenue for reporting KPI-linked payment terms, subject to discussion with SDRs and the CFTC if required. See Division of Market Oversight, CFTC, Technical Specification: Parts 43 and 45 swap data reporting and public dissemination requirements (September 17, 2020) (explaining that 'other payment' data elements "capture some types of payments linked to the derivative transaction but that are not regular periodic payments")

[60] Including Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation (SFDR)) and Regulation 2020/852 on the establishment of a framework to facilitate sustainable lending (Taxonomy Regulation)

Other financial products (as defined by the SFDR directly and through reference to wider pieces of EU financial regulatory law) may also be of relevance in a derivatives context, depending on how the financial products have been constructed[61].

In cases where it applies, the SFDR establishes a range of sustainability-related transparency and disclosure requirements. These include disclosures on websites, periodic reporting and pre-contractual disclosures.

The SFDR includes requirements for financial market participants to publish the following on their websites:

- Information about their policies on the integration of sustainability risks in their investment decision-making process[62];

- Where they do consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts[63], taking account of their size, the nature and scale of their activities and the types of financial products they make available. Where they do not consider adverse impacts of investment decisions on sustainability factors, clear reasons for why they do not, including information on whether and when they intend to consider these adverse impacts (although this derogation cannot now be used by financial market participants that have more than 500 employees)[64];

- Information on how their remuneration policies are consistent with the integration of sustainability risks[65]; and

- For financial products that promote environmental and/or social characteristics or have sustainable investment or carbon emissions reduction objective(s): (i) a description of the environmental or social characteristics or the sustainable investment objective(s) in question; (ii) information on the methodologies used to assess, measure and monitor the environmental or social characteristics or impact of the sustainable investments selected for each relevant financial product. This includes its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or overall sustainable impact of the financial product; (iii) any so-called Article 11 information[66]; and (iv) any Article 8[67] and/or Article 9[68] information[69].

[61] The definition of financial product covers: (A) certain insurance-based investment products (IBIPs); alternative investment funds (ie, collective investment undertakings that raise capital from a number of investors with a view to investing in accordance with a defined investment policy but do not require authorization under Article 5 of Directive 2009/65/EC), certain pension products, pension schemes and pan-European personal pension products (PEPPs), and any authorized undertakings for collective investment in transferable securities (UCITS) (ie, undertakings that can hold derivatives)

[62] Article 3, SFDR

[63] The information should include the points as set out in Article 4(2), SFDR

[64] Article 4, SFDR

[65] Article 5, SFDR

[66] Information on the environmental objective(s) to which the investment underlying the financial product contributes, and a description of how and to what extent the investments underlying the financial product relate to economic activities that qualify as environmentally sustainable under the Taxonomy Regulation

[67] Article 8 information: If a financial product promotes environmental and/or social characteristics (in whole or in part), pre-contractual disclosures should also cover: (a) information on how those characteristics are met; and (b) if an index has been designated a reference benchmark, information on whether and how this index is consistent with those characteristics (and an indication of where the methodology used for calculating the index can be found)

[68] If a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the following needs to be disclosed: (a) information on how the designated index is aligned with that objective; (b) an explanation of why and how the designated index aligned with that objective differs from a broad market index; and (c) an indication of where the methodology used for the calculation of the index can be found

[69] Article 10, SFDR

Financial market participants will have additional obligations from July 1, 2022 to produce periodic reports on financial products that promote environmental and/or social characteristics or have a sustainable investment or carbon emissions reduction objective[70], which then need to be disclosed in an appropriate manner[71]. These reports relate to:

- The extent to which any environmental or social characteristics are met (where the relevant product promotes environmental and/or social characteristics);
- For financial products that have sustainable investment as their objective, either:
  - The overall sustainability-related impact of the financial product by reference to relevant sustainability indicators; or
  - If an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and a broad market index using sustainability indicators; and
- Financial products that promote environmental characteristics, have a sustainable investment or carbon emissions reduction objective and invest in an economic activity that contributes to an environmental objective, meaning they qualify as sustainable investments under the SFDR.

The SFDR also contains requirements on pre-contractual disclosures. For example, financial market participants must include the following information in their pre-contractual disclosures: (a) the manner in which sustainability risks are integrated into their investment decisions; and (b) the results of an assessment of the likely impacts of sustainability risks on the returns of the financial products they make available[72].

From December 30, 2022, financial market participants that consider the principal adverse impacts of their investment decisions on sustainability factors are required to include additional information in pre-contractual disclosures: (a) the manner in which sustainability risks are integrated into their investment decisions; and (b) the results of an assessment of the likely impacts of sustainability risks on the returns of the financial products they make available[73].

Other additional pre-contractual disclosures will also be required in due course for financial products that promote environmental characteristics, with the disclosures needing to contain additional information set out in the Taxonomy Regulation.

Various regulatory technical standards (RTSs) are under development, which will describe what has to be disclosed more fully[74]. These draft standards include several references relevant to derivatives.

[70] Article 11, SFDR

[71] See Article 11(2), SFDR for what constitutes an appropriate manner for these purposes

[72] Article 6, SFDR

[73] Article 7, SFDR

[74] The draft regulatory technical standards as set out in the Final Report on Draft Regulatory Technical Standards, February 2, 2021 and as further amended by the Final Report on Draft Regulatory Technical Standards, October 22, 2021

In the context of Article 8 information linked to pre-contractual disclosures, the RTSs confirm that, where a financial product uses derivatives[75] to attain the environmental or social characteristics promoted by the financial product, a description of how the use of those derivatives attains those characteristics should be disclosed[76]. A similar requirement exists for Article 9 information and pre-contractual disclosures[77]. This also appears in the context of disclosures in periodic reports[78].

In addition, the RTSs require financial market participants to calculate and report on the extent to which their relevant Taxonomy Regulation-covered investments are taxonomy aligned. The key calculation uses the following formula:

$$\frac{\textit{Market value of all taxonomy-aligned investments of the financial product}}{\textit{Market value of all investments of the financial product}}$$

It is understood that derivatives should not generally be included in the numerator. The relevant European Supervisory Authorities (ESAs) that developed the RTSs have noted:

"While there may be legitimate cases for derivatives to be recognised for directly contributing to taxonomy-aligned economic activities, out of an abundance of prudence the ESAs prefer to exclude derivatives for the time being. This issue may be reconsidered in the future once there may be more evidence in this area to allow a different conclusion."

"However, the ESAs agree that netting should be recognised in the numerator, to ensure a fair representation of the economic exposure to securities in the numerator."

If the RTSs become law as currently drafted, many SLDs would not be able to be recognized as contributing towards taxonomy-aligned economic activities for these purposes (at least, not in the short term).

The disclosure requirements under US law apply to a narrower range of products. Only SLDs characterized as SBS may be subject to specific disclosure requirements in certain circumstances. Although there has been no US federal legislative movement on ESG-related disclosures, regulatory agencies are assessing the potential use of their existing authorities[79]. General risk disclosure requirements applicable to derivatives may need to be tailored and reconsidered to address KPIs or their cashflows.

In the UK, there has been an increase in political and regulatory action in recent years – in particular, to address greenwashing concerns. The UK government recently launched a new taskforce to develop the UK's own green taxonomy and tackle greenwashing in the financial sector. Regulators are also increasingly focusing on firms that mislead consumers about the sustainability of their funds. In parallel, the UK has looked at reporting in accordance with the Task Force on Climate-Related Financial Disclosures and has introduced (or is consulting on the introduction of) various laws mandating disclosures under this framework.

[75] Within the meaning of Article 2(1)(29) of Regulation (EU) No 600/2014 of the European Parliament and of the Council

[76] Article 16(1)(b), RTS

[77] Article 24(1)(b), RTS

[78] Article 59(a), RTS; Article 65(a), RTS

[79] The SEC is expected to propose a rulemaking on ESG disclosures for the end of 2021, which is expected to be relevant to several SEC divisions, including corporate finance, investment management and enforcement. The CFTC and the federal banking regulators have also mentioned ESG disclosures in agency and advisory committee releases

In this context, the UK Financial Conduct Authority (FCA) published a discussion paper on sustainability disclosure requirements and investment labels in November 2021[80]. Comments on this issue have been requested by January 7, 2022. The discussion paper will be used to help inform the FCA's policy proposals, which will be issued for consultation in the second quarter of 2022.

Among other things, the discussion paper raises questions about the role of derivatives, short-selling and securities lending in the context of sustainable investing. For example, it states:

"The debate over the role of derivatives in ESG investing is ongoing. Certain ESG derivatives are being launched where the payoff or the underlying reflect certain sustainability-related performance criteria or characteristics. By contrast, others might consider 'traditional' derivatives to be more appropriate for managing sustainability-related risks. We welcome views from stakeholders on whether the use of derivatives in pursuing sustainability strategies should have a bearing on the classification of relevant investment products"[81].

For entities that operate globally, it will be important to ensure that any disclosures relating to SLDs (in particular, covering progress towards achieving ESG KPI targets and overall ESG-related objectives) are accurate and verifiable.

Benchmark-related Considerations

Market participants should consider benchmark-related obligations when entering into SLDs. This is primarily an issue under EU and UK law, where specific legislation has been enacted[82].

Under relevant EU and UK legislation, the definition of a benchmark includes, among other things, an index used to determine the amount payable under a financial instrument or contract or the value of a financial instrument. Where KPIs reference or incorporate indices, there is therefore a possibility that these indices could fall within the definition of a benchmark. This is because whether the KPI is met determines the cashflows under the SLD – by extension, the amount payable under an SLD could be seen as being determined by reference to indices if they are incorporated into the KPIs.

EU and UK benchmark legislation regulates in-scope benchmarks and imposes obligations on benchmark users. In these circumstances, counterparties may need to consider the application of relevant EU and UK benchmarks legislation to their SLDs.

[80] DP21/4

[81] Paragraphs 3.41 – 42, DP

[82] In the EU, the relevant legislation is Regulation (EU) No 575/2013 of the European Parliament and of the Council of June 26, 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, as amended from time to time (EU Benchmarks Regulation (BMR)). In the UK, the relevant legislation is the EU BMR as it forms part of retained EU law as defined in the Withdrawal Act

There is currently no corresponding congressional mandate on benchmarks regulation in the US. Nonetheless, the IOSCO principles used as a basis for the EU and UK benchmark legislation have been endorsed by the Financial Stability Board and the Federal Reserve Bank of New York (FRBNY), among others[83]. These principles were based in part on US enforcement of the Commodity Exchange Act and antitrust laws with respect to benchmark manipulation, as well as the CFTC's informal input[84]. Many US-based benchmark administrators, including the FRBNY and a number of financial institutions, maintain policies in compliance with the IOSCO principles[85].

Bankruptcy/Recovery and Resolution

When entering into SLDs, counterparties should consider requirements related to recovery and resolution under EU, UK and/or US law[86]. These regulations provide specific protections and safe harbors that only extend to certain arrangements. Market participants should therefore consider whether the SLD-specific characteristics impact the application of these safe harbors to their transactions.

In the US, to the extent an SLD is not classified as a swap, it may not be covered by the safe harbor under the US Bankruptcy Code's general automatic stay available for certain qualified financial contracts[87]. Furthermore, any KPI-linked cashflows added to or referencing an agreement that would otherwise be a swap may not be covered by relevant legal opinions.

In the UK and EU, the relevant safe harbor applies to set-off and netting arrangements[88]. To qualify for the safe harbor, an arrangement is required to relate to the assets and liabilities arising under derivatives and financial contracts. To the extent an SLD is a derivative, its SLD-specific characteristics (for example, the KPI-related cashflows) should not affect compliance with this requirement and the normal recovery-and-resolution-related considerations and safe harbors should apply.

Prudential Requirements

There is little guidance from UK, EU and US prudential regulators on requirements specifically applicable to SLDs beyond those applicable for derivatives and other types of non-derivatives transactions. For the moment, firms subject to regulatory prudential obligations will likely be required to calculate the risk-weighted exposures of SLDs as they would for any other exposures.

In other words, most participants in these markets would likely assess SLDs in the same way as they assess other derivatives (or if SLDs are not derivatives, then other non-derivatives exposures). However, US prudential regulators are currently discussing the nature of the risk that is being assumed with in-scope market participants.

[83] Financial Stability Board, LIBOR and Other Benchmarks (last visited October 24, 2021), www.fsb.org/work-of-the-fsb/market-and-institutional-resilience/libor-and-other-benchmarks/

[84] See IOSCO, Principles for Financial Benchmarks: Final Report (July 17, 2013)

[85] For example, see FRBNY, Statement of Compliance with the IOSCO Principles for Financial Benchmarks (July 14, 2021), www.newyorkfed.org/medialibrary/media/markets/IOSCO-statement-of-compliance-jul2021; Goldman Sachs, IOSCO Principles for Financial Benchmarks – Compliance Statement (July 2020), www.goldmansachs.com/what-we-do/global-markets/systematic-trading-strategies/copy-of-iosco-compliance.pdf

[86] For EU law purposes, the relevant legislation is Directive 2014/59/EU of the European Parliament and of the Council of May 15, 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, as amended from time to time and as transposed into the relevant member state law. For the purposes of UK law, the relevant legislation is the Banking Act 2009. For the purposes of US law, the relevant legislation is the US Bankruptcy Code

[87] For example, see 11 U.S.C. 362(b)(6), (7), (17), (27), 362(o)

[88] For example, in the context of partial property transfers, as forest out in the relevant legislation

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.