ISDA Safe, Efficient Markets

Draft date: 27 August 2020

**ISDA – ESAs Joint Consultation Paper on ESG disclosures under Regulation (EU) 2019/2088**

ISDA welcomes the opportunity to comment on the draft regulatory technical standards set out in the ESAs' Joint Consultation Paper on ESG disclosures[1].

In particular, we would welcome confirmation that the proposed obligations in Chapters III and IV relate only to financial products for which financial market participants are required to comply with the requirements for transparency in pre-contractual disclosures under Articles 8 and 9, and so relate only to financial products which are marketed on or after the date of application of the Sustainable Finance Disclosures Regulation (i.e., 10 March 2021).

ISDA members would prefer to include a separate section on information on how the use of derivatives meets each of the environmental or social characteristics or sustainable investment objectives promoted by the financial product, under Articles 19 and 28 of the RTS. This relates to the role of derivatives as a risk-management tool, requiring that disclosures in relation to the 'use of derivatives' should be different than disclosures for other financial products such as equities and bonds. For example, derivatives may be used in an ESG fund to hedge against currency and interest rate risks, with the derivatives themselves not having a sustainable investment objective.

Furthermore, ISDA is of the view that the absence of proportionality considerations, taking into account the size and complexities of financial market participants, i.e. smaller asset managers and SMEs, may discourage those companies from enhancing their analysis and disclosures of ESG factors, as argued by AIMA and MFA. Therefore, the ESAs should consider whether the opt-in regime for principal adverse impacts (PAI) should be more nuanced and allow smaller financial market participants to opt-in based on subsets of the 32 indicators in considerations, rather than allowing only for a binary choice between no PAI considerations and the full disclosure of 32 indicators.

In addition, ISDA supports AIMA and MFA's suggested approach with respect to the materiality of adverse impact indicators in Table 1. We believe that companies should only be required to disclose indicators set out in Table 1 which are relevant and material to the activities of the company. In a different event, this may lead financial market participants from refraining to opt-in to the PAI regime. Should some indicators be mandatorily reported, then we would recommend limiting the list to a few key indicators, and allowing for the rest of the indicators to be reported depending on the materiality of these indicators If these indicators are required always to be reported as "principal adverse impacts", ISDA would recommend in particular that the metrics in Table 1 be adjusted so that the report may indicate "not applicable" if companies do not have certain policies in place because those policies would be irrelevant to their business, and so only adverse results would be required to be reported. ISDA would also like to endorse AIMA and MFA's statement in relation to the practice of short selling by fund managers, as it can be a helpful tool when considering ESG in their investment process and

[1] https://eba.europa.eu/regulation-and-policy/transparency-and-pillar-3/joint-rts-esg-disclosure-standards-financial-market-participants

helps improve market transparency and price discovery with respect to ESG impacts on companies.

Finally, as suggested by AIMA and MFA, ISDA would like to encourage the ESAs to further clarify that the concepts of "principal adverse impact" and 'sustainable investment objective' refer to definitions in EU law, as this would help EU financial market participants in their marketing endeavours outside of the EU.

**About ISDA**

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 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.

**Question 1: Do you agree with the approach proposed in Chapter II and Annex I – where the indicators in Table 1 always lead to principal adverse impacts irrespective of the value of the metrics, requiring consistent disclosure, and the indicators in Table 2 and 3 are subject to an "opt- in" regime for disclosure?**

We are concerned that not all of the indicators in Table 1 will always lead to principal adverse impacts, and that while consistent disclosure of these indicators may be useful, presenting them as "principal adverse impacts" may sometimes be misleading (and potentially have detrimental effects on smaller companies or start-ups). For example:

- **Biodiversity**: the biodiversity indicators listed in Table 1 will not be relevant to all financial products or companies. If a financial product involves investments in companies which do not "assess, monitor or control" pressures corresponding to the indirect and direct drivers of biodiversity and ecosystem change, or which do not have a deforestation policy, simply because this is not relevant to their business, this would be reported as a "principal adverse impact" even though in fact there is no adverse impact.

- **Social and employee matters**: some of the metrics referenced in this section could potentially indicate positive (rather than adverse) impacts. For example, the gender pay gap may be very low, or board gender diversity may be excellent. In these cases, the approach proposed in Chapter II and Annex I may result in positive metrics being required to be reported as "principal adverse impacts".

If these indicators are required always to be reported as "principal adverse impacts", we would recommend that the metrics in Table 1 be adjusted so that the report may indicate "not applicable" if companies do not have certain policies in place because those policies would be irrelevant to their business, and so only adverse results would be required to be reported.

**Question 2: Does the approach laid out in Chapter II and Annex I, take sufficiently into account the size, nature, and scale of financial market participants activities and the type of products they make available?**

**Question 3: If you do not agree with the approach in Chapter II and Annex I, is there another way to ensure sufficiently comparable disclosure against key indicators?**

As mentioned in our response to question 1, we would recommend that the metrics in Table 1 be adjusted so that the report may indicate "not applicable" if companies do not have certain policies in place because those policies would be irrelevant to their business, and that where the relevant metrics may yield positive results (e.g., good board diversity or a low gender pay gap) only adverse results would be required to be reported.

**Question 4: Do you have any views on the reporting template provided in Table 1 of Annex I?**

**Question 5: Do you agree with the indicators? Would you recommend any other indicators? Do you see merit in including forward-looking indicators such as emission reduction pathways, or scope 4 emissions (saving other companies´ GHG emissions)?**

**Question 6: In addition to the proposed indicators on carbon emissions in Annex I, do you see merit in also requesting a) a relative measure of carbon emissions relative to the EU 2030 climate and energy framework target and b) a relative measure of carbon emissions relative to the prevailing carbon price?**

**Question 7: The ESAs saw merit in requiring measurement of both (1) the share of the investments in companies without a particular issue required by the indicator and (2) the share of all companies in the investments without that issue. Do you have any feedback on this proposal?**

**Question 8: Would you see merit in including more advanced indicators or metrics to allow financial market participants to capture activities by investee companies to reduce GHG emissions? If yes, how would such advanced metrics capture adverse impacts?**

**Question 9: Do you agree with the goal of trying to deliver indicators for social and employee matters, respect for human rights, anti-corruption and anti-bribery matters at the same time as the environmental indicators?**

We do agree with this goal. However, as mentioned in our response to question 1, not all of the metrics currently included in Table 1 will always result in an adverse impact. We would recommend that the metrics in Table 1 be adjusted so that the report may indicate "not applicable" if companies do not have certain policies in place because those policies would be irrelevant to their business, and that where the relevant metrics may yield positive results (e.g., good board diversity or a low gender pay gap) only adverse results would be required to be reported.

**Question 10: Do you agree with the proposal that financial market participants should provide a historical comparison of principal adverse impact disclosures up to ten years? If not, what timespan would you suggest?**

**Question 11: Are there any ways to discourage potential "window dressing" techniques in the principal adverse impact reporting? Should the ESAs consider harmonising the**

**methodology and timing of reporting across the reference period, e.g. on what dates the composition of investments must be taken into account? If not, what alternative would you suggest to curtail window dressing techniques?**

**Question 15: Do you agree with the balance of information between pre-contractual and website information requirements? Apart from the items listed under Questions 25 and 26, is there anything you would add or subtract from these proposals?**

**Question 16: Do you think the differences between Article 8 and Article 9 products are sufficiently well captured by the proposed provisions? If not, please suggest how the disclosures could be further distinguished.**

**Question 17: Do the graphical and narrative descriptions of investment proportions capture indirect investments sufficiently?**

We would welcome clarification from the ESAs on what they consider to be "indirect investments" (and in particular that this does not include derivative exposures to the relevant companies if the ESAs intend for information on use of derivatives to be captured under Articles 19 and 28 of the RTS).

**Question 18: The draft RTS require in Article 15(2) that for Article 8 products graphical representations illustrate the proportion of investments screened against the environmental or social characteristics of the financial product. However, as characteristics can widely vary from product to product do you think using the same graphical representation for very different types of products could be misleading to end-investors? If yes, how should such graphic representation be adapted?**

**Question 19: Do you agree with always disclosing exposure to solid fossil-fuel sectors? Are there other sectors that should be captured in such a way, such as nuclear energy?**

**Question 20: Do the product disclosure rules take sufficient account of the differences between products, such as multi-option products or portfolio management products?**

**Question 21: While Article 8 SFDR suggests investee companies should have "good governance practices", Article 2(17) SFDR includes specific details for good governance practices for sustainable investment investee companies including "sound management structures, employee relations, remuneration of staff and tax compliance". Should the requirements in the RTS for good governance practices for Article 8 products also capture these elements, bearing in mind Article 8 products may not be undertaking sustainable investments?**

**Question 22: What are your views on the preliminary proposals on "do not significantly harm" principle disclosures in line with the new empowerment under the taxonomy regulation, which can be found in Recital (33), Articles 16(2), 25, 34(3), 35(3), 38 and 45 in the draft RTS?**

**Question 23: Do you see merit in the ESAs defining widely used ESG investment strategies (such as best-in-class, best-in-universe, exclusions, etc.) and giving financial market participants an opportunity to disclose the use of such strategies, where relevant? If yes, how would you define such widely used strategies?**

**Question 24: Do you agree with the approach on the disclosure of financial products' top investments in periodic disclosures as currently set out in Articles 39 and 46 of the draft RTS?**

**Question 25: For each of the following four elements, please indicate whether you believe it is better to include the item in the pre-contractual or the website disclosures for financial products? Please explain your reasoning.**

**a) an indication of any commitment of a minimum reduction rate of the investments (sometimes referred to as the "investable universe") considered prior to the application of the investment strategy – in the draft RTS below it is in the pre-contractual disclosure Articles 17(b) and 26(b);**

**b) a short description of the policy to assess good governance practices of the investee companies – in the draft RTS below it is in pre-contractual disclosure Articles 17(c) and 26(c);**

**c) a description of the limitations to (1) methodologies and (2) data sources and how such limitations do not affect the attainment of any environmental or social characteristics or sustainable investment objective of the financial product – in the draft RTS below it is in the website disclosure under Article 34(1)(k) and Article 35(1)(k); and**

**d) a reference to whether data sources are external or internal and in what proportions – not currently reflected in the draft RTS but could complement the pre-contractual disclosures under Article 17.**

**Question 26: Is it better to include a separate section on information on how the use of derivatives meets each of the environmental or social characteristics or sustainable investment objectives promoted by the financial product, as in the below draft RTS under Article 19 and Article 28, or would it be better to integrate this section with the graphical and narrative explanation of the investment proportions under Article 15(2) and 24(2)?**

[ISDA considers that on balance it would be preferable to include a separate section on information on how the use of derivatives meets each of the environmental or social characteristics or sustainable investment objectives promoted by the financial product, under Articles 19 and 28 of the RTS.]

The requirements for the graphical and narrative explanations of the investment proportions under Articles 15(2) and 24(2) appear to have been drafted with direct investments in equities or debt instruments in mind. While derivatives may be used to obtain an exposure to these instruments (and so a derivative could be included in a graphical representation in the same way as these instruments), this will not always be the case and requiring all derivatives that may be used in structuring a particular product to be represented in the same way seems likely to lead to confusion for investors.

In particular, derivatives may be used in particular products in ways which are not clearly linked to the sustainable objectives of the overall product – for example, derivatives may be used to hedge currency or interest rate risk. These derivatives would not be categorised as "sustainable investments" and including them in the graphical and narrative explanations of the sustainable investment objective of the financial product would lead to misleading results.

However, we also consider that even where information on use of derivatives is provided separately under Articles 19 and 28 it will be necessary to provide some explanation in order to clarify to investors how the information is presented.

Where derivatives are used in a product in a way that may qualify them as "sustainable investments", investors may expect to see information on these derivatives set out in the graphical and narrative explanations under Articles 15(2) and 24(2). It may be appropriate for financial market participants to include a note in the graphical and narrative explanations pointing investors to the separate section on use of derivatives in order to give them a complete picture. This may particularly be the case where investors are familiar with other pre-contractual disclosures required by EU law (e.g., UCITS KIIDs or PRIIPS KIDs), which treat all underlying products in the same way and do not address derivatives separately.

It would also be useful for the RTS to clearly indicate that derivatives should only be covered in one section (either in Articles 19 and 28, or in Articles 15(2) and 24(2), whichever approach the ESAs adopt in the final RTS). If this clarification is not provided, there is a risk that some financial market participants may include derivatives in both sections, or cherry pick the circumstances in which they include derivatives in the graphical and narrative explanation (e.g., only including them when they contribute positively to the proportion of sustainable investments and excluding them when they would dilute this proportion). This would make these disclosures significantly less useful to investors and would reduce the extent to which it is possible to make comparisons between similar products.

If the ESAs do adopt the approach of requiring separate disclosure on use of derivatives under Articles 19 and 28, we would also welcome confirmation that financial market participants may satisfy this requirement by including a statement that their use of derivatives is not connected to the environmental or social characteristics promoted by the financial product, if this is the case (e.g., as mentioned above, in the case of currency or interest rate derivatives). If financial market participants are required to identify these derivatives as not meeting the environmental or social characteristics promoted by the financial product, this seems likely to result in misleading information for investors.