JOINT COMMITTEE OF THE EUROPEAN SUPERVISORY AUTHORITIES

Reply form

on the Joint Consultation Paper on the review of SFDR Delegated Regulation regarding PAI and financial product disclosures

International Swaps and Derivatives Association (ISDA)

4 July 2023

12 April 2023
ESMA34-45-1218

Responding to this paper

The ESAs invite comments on all matters in the Joint Consultation Paper and in particular on the specific questions in this reply form. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives the ESAs should consider.

ESMA will consider all comments received by **4 July 2023.**

Instructions

In order to facilitate analysis of responses to the Joint Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Joint Consultation Paper in this reply form.
- Please do not remove tags of the type <ESMA_QUESTION_SFDR_1>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
- When you have drafted your responses, save the reply form according to the following convention: ESMA_CP SFDR Review_nameofrespondent.

  For example, for a respondent named ABCD, the reply form would be saved with the following name: ESMA_CP SFDR Review_ABCD.
- Upload the Word reply form containing your responses to ESMA’s website (**pdf documents will not be considered except for annexes**). All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input - Consultations’.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESAs' rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the ESAs is based on Regulation (EU) 2018/1725[1]. Further information on data protection can be found under the [Legal notice] section of the EBA website and under the [Legal notice] section of the EIOPA website and under the [Legal notice] section of the ESMA website.

[1] Regulation (EU) 2018/1725 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC, OJ L 295, 21.11.2018, p. 39.

General information about respondent

Name of the company / organisation	ISDA
Activity	Banking sector
Are you representing an association?	☒
Country/Region	Europe

The International Swaps and Derivatives Associations (ISDA) appreciates the opportunity to provide comments to the Joint Consultation Paper on the review of SFDR Delegated Regulation regarding PAI and financial product disclosures (the "Consultation Paper"). ISDA is committed to supporting the transition towards a more sustainable economy and recognises that derivatives have an important role to play in achieving such transition. Given our role as the voice of safe and efficient global derivatives markets, our comments are limited to questions of the Consultation Paper that reference derivatives instruments.

We are pleased to share our recommendations to inform the ongoing discussion regarding the calibration of the EU regulatory framework for derivatives from a sustainability perspective. We are therefore pleased to provide input into the ESAs' important work regarding the review of the SFDR from a derivatives perspective. The aim of our response is to be educational in explaining the role of derivatives in a sustainable economy and the mathematical consequences of measuring them / accounting them in ESG disclosure metrics.

In line with other financial industry associations, we would like to note our keen interest to develop a common cross-industry methodology for the measurement of derivatives against the EU's sustainable finance regulatory framework as different approaches might expose market participants and underlying investors to a variety of different methodologies, increasing inconsistency and running counter to the ESAs' intentions.

Therefore, we kindly request that the ESAs allow the industry additional time to reach a consensus on the treatment of derivatives and provide maximum consistency across the relevant legal frameworks through continuous collaboration with the PSF and the European Commission and relevant industry stakeholders. We are also willing to engage in further discussions with regulators regarding this matter.

Questions

Q14: Do you agree with the proposed treatment of derivatives in the PAI indicators or would you suggest any other method?

1. Role of derivatives in the economy

While derivatives can generally be considered to be a more indirect form of investment that does not provide direct financing to companies (such as in primary markets only), it is still necessary to consider how they contribute to companies' cost of capital i.e. cost that a company will have to pay when it will need financing through debt or equity issuances (in secondary markets)[1].

As reiterated in the FCA CP 22/20 October 2022 on SDR there are 3 main channels by which an investor may contribute to positive outcomes for the environment and/or society or influence corporate behaviour: (i) engaging (with or without having to own shares), (ii) sharing corporates' business risk & modifying the cost of capital (via changing the amount of capital available at a given cost) and (iii) funding (issuance in the primary market) [2].

Derivatives have more of the second type of impact relative to the first type of impact. This second type of impact, which is often dismissed in sustainable discussions, is a very relevant and strong method of influence with higher intensity than through holding physical shares thanks to leverage. Derivatives allow investors to be exposed to companies' equity and debt hence contribute to the definition of their cost of capital / refinancing in the future. This impact is permanently present in actively traded markets. The degree of influence gained through this second channel is a direct function of how much positive or negative economic exposure investors are willing to take on a given corporate and hold on to.

Owning a physical security may allow the three types of impacts, however lot of cash would be required to meet the investment needs required to attain 2050 goals.

Physical ownership is not a necessary criterion to demonstrate impacts (buy or selling a share to / from someone else doesn't provide capital to the corporate nor does that transfer of ownership has a direct impact on the real world), therefore its inclusion or exclusion should not be a condition for the calculation of ESG indicators such as PAI, taxonomy alignment or Sustainable Investment.

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[2] Quantification of investors' impact on a trade is illustrated by academia (Schiller, Gabaix, Bouchaud) "In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis" – Oct 2020 – revised May 2022 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3686935
JP Bouchaud "The Inelastic Market Hypothesis: A Microstructural Interpretation" - Jan 2022
https://arxiv.org/pdf/2108.00242.pdf
https://www.risk.net/investing/quant-investing/7871901/an-old-model-can-shed-new-light-on-how-flows-shape-prices.
The size of the markets underpinning impact 3 versus impact 2: comparison of size of primary vs. secondary markets for London Stock Exchange: New Issuance & IPOS (2021): total raised: GBP 15.3bn, versus value traded (all markets, 2021): GBP 1,248.5bn.

2. Regarding the PAI proposals

   1. Scope of derivatives

We strongly recommend a consistent metric across the three ratios (PAIs, Taxonomy and Sustainable Investments). Deviation from a harmonised approach that incorporates derivatives solely based on the risk of greenwashing contradicts the treatment of these matters outlined in the relevant UCITS Guidelines and AIFMD L2 Regulations whilst it fails to align with risk management objectives and actual practices.

The SFDR regulations are designed to increase market transparency, prevent greenwashing, and direct capital towards more sustainable businesses and financial products. In order to determine the right treatment for derivatives, it is important for the relevant metrics to be designed in a manner so that they provide an accurate perspective on sustainability impacts and risk, prevent greenwashing, and enable investors to make well informed investment decisions.

The ESAs aim to clarify how derivatives can count towards PAI indicators by suggesting their inclusion in the numerator of the PAI indicators where they cause an adverse impact, including a methodology of how these should be calculated. This can have important implications for the overall treatment of derivatives in the calculation of exposures to sustainable activities in the Taxonomy Article 8 entity-level reporting indicator and ISDA's work therein.

As a reminder of ISDA's policy and advocacy work on the treatment of derivatives, please see below our previous policy submissions to the ESAs on this matter:

- ISDA's response to the review of ESMA's guidelines on the MiFID II product governance rules
- ISDA's response to ESAs Call for Evidence on Greenwashing
- ISDA's response to ESMA Guidelines on funds' names using ESG or sustainability-related terms

As mentioned above, we believe that what needs to be measured is the exposure of a given investor, in cash or derivatives to a company i.e. to its equity and debt. Derivatives that must be included in PAI numerator are those with equity and debt underlyers. We also believe that derivatives should be treated in a consistent manner in the numerator and the denominator of the relevant ESG ratios to avoid any mathematically inconsistent outcomes.

However, other instruments and asset classes may also have a derivative footprint, and thus further investigation is needed in an ESG context as part of the deliberations of the forthcoming ad hoc expert group on derivatives under PSF 2.0 in view of the latter's consideration of such asset classes in its Taxonomy and Usability report[3].

[3] Platform on Sustainable Finance's recommendations on data and usability of the EU taxonomy (europa.eu)

2. Delta

It is crucial to provide further clarification on how derivatives' exposures should be assessed. This is necessary due to various differentiating factors and data challenges that exist. We welcome the consideration of derivatives as an investment decision measured according to their equivalent position in the underlying asset, also called Delta. This is consistent with the recommendation of the EU PSF and our response to the funds naming consultation relating to Sustainable Investments (SI).

In particular, when tracing back the derivatives' conversion methodology to the options set out in the data and usability report produced by the PSF on the treatment of derivatives (i.e. outright exclusion or inclusion on the basis of Underlying value * Delta), the approach is similar to the examples in Annex II of the AIFMD L2 Regulations for Plain Vanilla Bond options and Plain vanilla equity options. However, the Consultation Paper does not reference the PSF's work on the treatment of derivatives (i.e. the PSF has recommended further in-depth analysis on the review of derivatives ahead of the 2024 review of the Article 8 Taxonomy DA)[4].

Therefore, we are of the view that the proposed conversion methodology provides a useful reference point for assessing exposure calculations for various derivative products and provides a very detailed view of the different approaches (and the scope of instruments should be aligned with the ongoing work on derivatives under PSF 2.0).We would urge the ESAs to provide maximum consistency in derivatives' treatment across the various KPIs and indicators in the EU Taxonomy and SFDR Regulations as well as in the MiFID II sustainability preferences framework through continuous collaboration with the PSF and the European Commission in order to avoid fragmented approaches that could lead to suboptimal outcomes.

3. Long/short netting

The calculation methodology and resulting metrics as currently proposed exhibit information loss, in particular in relation to financial market participants who use long and short positions, and employ derivatives.

4. We thus welcome the inclusion of long and short derivatives positions as in order to embrace the full economic exposure on a given issuer, both the amount of risk carried out by long and short positions must be reflected for their full value. We also welcome the ESAs reiterating this economic reality that long and short should be netted at the level of an individual counterpart. Physical investment

Regarding the option for financial market participants (FMPs) to disregard derivatives if they cannot show that they result in a physical investment in the underlying asset, we would disagree with this criterion. As per above the ownership of a physical asset is not a criterion to evidence impacts. Therefore, the inclusion of exclusion of this criterion is irrelevant to capture investor's impacts when using derivatives. The principles above should equally be applied consistently to the other indicators (Sustainable Investments, Taxonomy, PAIs).

[4] Idem

Therefore, the physical ownership of the underlying asset should not be a precondition for the eligibility of derivatives for inclusion in the relevant KPIs.

Q15: What are your views with regard to the treatment of derivatives in general (Taxonomy-alignment, share of sustainable investments and PAI calculations)? Should the netting provision of Article 17(1)(g) be applied to sustainable investment calculations?

1. Consistency across KPIs

It has previously been recognised[5] that the inconsistent treatment of derivatives within SFDR was highly confusing and would have detrimental consequences on the EU derivatives market:

- Investors will likely reduce their derivatives activities to favour cash investments for the sake of achieving better Taxonomy or SI disclosures;
- As per above, it ignores the role of derivatives to foster investments by providing companies with a reduction in their cost of capital and market risk tailored to their risk appetite and profile, and/or by opening them access to wider markets and investment opportunities;
- It ignores the role that derivatives play for retail investors helping them participate to the equity market via capital protected products. Retail appetite to sustainable products is likely to reduce as a consequence;

We therefore urge the ESAs to revise their proposals regarding Taxonomy and SI in order that, like PAIs, both long and short derivative positions are taken into account to compute the Taxonomy and SI calculations. The amount of risk carried both by the long and short world is too significant to be dismissed. We believe full transparency on risks must be given to investors and end investors. Partial information would only increase the risk of greenwashing.

2. Methodology / netting

We agree with the reference to the Short Selling regulation in the sense that both long and short derivative positions should be netted for their full algebraic value at issuer level. As explained above, all impacts must be captured to compute a meaningful green intensity of any capital allocation.

We do not agree with the cross-reference to the underlyers of “share capital and sovereign debt” in the Short Selling regulation as the scope of underlyers authorised to be captured and netted.

Companies are real actors of the economy able to influence the re-allocation of capital flows toward the green sectors, Taxonomy aligned activities and the transition. As noted above, by sharing companies’ business risk, investors contribute to define companies’ cost of capital. Derivatives (long and short) whose underlyings are companies’ equity and corporate debt are the obvious ones that can create an impact and are assessable against the EU Taxonomy and sustainability objectives / ESG characteristics, proportionately to the exposure they offer to their underlyings (also called “delta” as per above in response to Q14).

3. Timeline/implementation

With regards to the timeline of the operationalization and implementation of the new reporting rules, we would suggest a phase-in approach because we consider mid 2024 as providing a very narrow implementation window for FMPs.

Q16: Do you see the need to extend the scope of the provisions of point g of paragraph 1 of Article 17 of the SFDR Delegated Regulation to asset classes other than equity and sovereign exposures?

Please see our responses to questions 14 and 15 above.

We would also note that the suggested wording includes a new definition of 'current investments'. In this regard, we welcome the addition made regarding the consideration of 'all' underlying investments in the calculation, and suggest to further precise the definition of the meaning of 'current'.

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