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Sustainability Disclosure Requirements (SDR)
ESG Strategy
Financial Conduct Authority
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Dear Gwil,

DP21/4: Sustainability Disclosure Requirements and investment labels

The International Swaps and Derivatives Association (**ISDA**) welcomes the opportunity to respond to FCA's Discussion Paper on Sustainability Disclosure Requirements and investment labels.

1. Executive summary

- Products not directly targeted at retail consumers such as derivatives products traded on Recognised Investment Exchanges (RIE) should not be within scope of the proposed labelling regime.
- Climate Transition benchmarks should be classified as Sustainable – Transitioning while products tracking Paris-aligned benchmarks should be classified as Sustainable – Aligned.
- The recent growth in demand for listed and over-the-counter (OTC) ESG derivatives illustrates that these products are a core component of sustainable investment strategies and can play a very important role in achieving the goals outlined by the UK Government in its Green Finance Strategy, and financial market participants should be able to use them freely.
- The EU regulatory framework regarding the role of derivatives in sustainable finance is overly prescriptive and likely to remain in flux for several years. It may therefore be an inappropriate reference against which to compare parallel regulatory initiatives in other jurisdictions, including the UK. A sensible recommendation for the FCA to consider would be a principles-based approach to setting out sustainability disclosure requirements and investment labels.

For the purpose of this submission, ISDA is endorsing the position of the Alternative Investment Management Association (AIMA) and the Alternative Credit Council (ACC) on the role of short selling in sustainable investing as well as the position of the International Securities Lending Association (ISLA) on the role of securities lending in sustainable investing.

2. Responses

Question 2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of products than for others, please provide examples.

It is important to clearly define the scope of the labelling regime to products that are directly targeted at retail consumers and not at wholesale market participants. For example, requiring an investment label for exchange traded derivatives (ETDs) would not significantly contribute to the overarching policy objectives of enabling consumers to make effective choices about sustainable investment products, enhance trust or eliminate greenwashing. To avoid ambiguity with regards to the product classification and labelling regime, it would be helpful for the FCA to clearly set out in the upcoming draft rules and guidance that derivatives products traded on Recognised Investment Exchanges (RIE) are not within scope of the proposed labelling regime. Failure to achieve this will likely lead to a regime which is vague and places disproportionate regulatory burden that could harm the competitiveness of the UK's derivatives markets.

Question 11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

In respect of the potential approach to classification criteria set out in Box 3 of the Discussion Paper, it would naturally follow that products tracking Climate Transition benchmarks should be classified as Sustainable – Transitioning while products tracking Paris-aligned benchmarks should be classified as Sustainable – Aligned.

We would like to caution though against the setting out of the minimum labelling criteria for products tracking these two types of low carbon benchmarks in an overly prescriptive way that would likely disincentivise investments in these types of products. Moreover, it is essential that the product labels are clear and distinguishable with a view to allow consumers to identify those most appropriate to their preferences.

As noted in the latest BIS Quarterly Review[1], *"the emerging consensus (G20 (2021)) is that, in an effective classification system, ESG assets will be those whose environmental and social benefits are material and consistent with broader sustainability goals (e.g. as set out in the Paris Agreement or the UN Sustainable Development Goals)"*.

Question 12: What do you consider the role of derivatives, short-selling and securities lending to be in sustainable investing? Please explain your views.

Contributory role of derivatives in sustainable finance

The financial sector is a key enabler of economic activity and plays a critical role in facilitating and accelerating the transition to a low carbon economy, and the transition to a sustainable economy will take a significant amount of long-term funding. ESG investments and the associated products to hedge those investments will be absolutely critical in the transition to a green economy, enabling companies to meet their sustainability goals effectively and efficiently.

Derivatives perform a critical role in economic activity by facilitating the raising and allocation of capital for green finance, helping businesses and investors better manage the risks to which they are exposed, and allowing market participants to more effectively align their exposures with risk tolerance and risk management requirements. The derivatives market also plays a major role in enhancing transparency through providing information on their underlying commodities, securities or assets. This can ultimately contribute to long-term sustainability objectives by bringing information about sustainability-related activities in the real economy into the financial markets, allowing investors to appropriately respond to economic actors' positive or negative contributions to the green transition.

The exponential growth of ESG markets over the past few years shows the need for forward prices for these assets and their related indices. Derivatives markets are a key component of mature secondary markets, and the recent growth in demand for listed and over-the-counter (OTC) ESG derivatives illustrates that these products are a core component of sustainable investment strategies, especially since the availability of liquid and transparent derivatives can fundamentally reduce funding and financing costs for share and bond issuers in the primary markets.

As markets for ESG investments develop and trillions need to be raised to finance the transition to a sustainable economy, the derivatives market will be critically important in facilitating the financing of green investments, including in their role as hedging tools to manage the associated risks. To this end, derivatives can play a very important role in achieving the goals outlined by the UK Government in its Green Finance Strategy, and financial market participants should be able to use them freely.

[1] https://www.bis.org/publ/qtrpdf/r_qt2112.pdf

This is because derivatives:

- can facilitate the raising and allocation of green capital towards sustainable investments at scale;
- help firms hedge risks related to ESG factors;
- facilitate transparency, price discovery and market efficiency; and
- contribute to long-termism, since longer-term investments can be enabled via the efficient hedging of investment risks.

The role of derivatives in sustainable finance is explored in greater detail in a July 2020 paper published by the Centre for European Policy Studies ("CEPS") and the European Capital Markets Institute ("ECMI").[2]

The financial sector is responding to the challenges in sustainable finance with a diverse range of product structures and transaction types in the derivatives market. While conventional derivatives can certainly be used to hedge green instruments such as green bonds[3], a new wave of sustainability-linked derivatives and exchange-traded ESG derivatives has also developed in recent years, alongside emissions trading derivatives, renewable energy and renewable fuels derivatives, and catastrophe and weather derivatives. In January 2021, ISDA published a research report that gives a valuable overview of such ESG-related derivatives products and transactions.[4]

Sustainability-linked Derivatives (SLDs)

Sustainability-linked products – whose liquidity, price transparency and attractiveness to investors can be further enhanced through the use of derivative instruments – can attract much-needed investment in the transition to a net zero economy. Such investments have long-term objectives and require a long-term orientation. One particular area of growth is sustainability-linked derivatives (SLDs), which have gained increasing prominence in the EU, UK and US.

As interest in such ESG-related derivatives products gains momentum, standardisation will be more important than ever because it is only through robust standards that products and markets can scale efficiently. In this context, please note ISDA's publication of a white paper outlining key performance indicators (KPIs) guidelines for SLDs.[5]

SLDs embed or create a sustainability-linked cashflow using KPIs that are designed to monitor compliance with environmental, social and governance (ESG) targets. KPIs are therefore critical to the effectiveness and integrity of the SLDs to which they relate. They need to be

[2] Derivatives-in-Sustainable-Finance.pdf (isda.org)

[3] For example, if an ESG fund uses interest rate swaps to hedge away interest rate risk from the return of the fund, then the fund's investment return would be less affected by changes in interest rates and more dependent on the return on the green investments the fund has made.

[4] Overview-ofESG-related-Derivatives-Products-and-Transactions.pdf (isda.org)

[5] Sustainability-linked-Derivatives-KPI-Guidelines-Sept-2021.pdf (isda.org)

accurately defined in order to have legal certainty over how they operate and impact cashflows and so they can be objectively verified. This will enhance the credibility of SLDs and the sustainability-linked market as a whole.

As SLDs are currently a niche and nascent market, the paper is intended to provide further information to market participants on the types of transactions that have been executed to date, along with guidance on the overarching principles that need to be considered when structuring KPIs. The guidance seeks to establish a transparent, common framework of best practices that can be applied across KPIs and their related SLDs more widely in a way that is specific, verifiable and transparent.

By establishing best practices and addressing key risks, the guidance seeks to help address greenwashing by encouraging adequate disclosure of how SLDs help attain sustainability objectives, therefore supporting the integrity of this developing market. The guidance also seeks to promote greater use of SLDs, which will help to build liquidity and ensure provide an effective tool for counterparties to participate in the transition to a green economy.

As market participants make greater use of SLDs 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 is why ISDA published another white paper which explores the regulatory implications of SLDs, including whether they could be classified as swaps under US regulations and/or over-the-counter (OTC) derivatives under EU and/or UK rules and, if so, what exemptions or exclusions might be available. The paper also considers the impact of sustainability-linked cashflows on derivatives that would otherwise be excluded or exempt from certain requirements under those regulatory regimes as well as compliance issues that market participants should consider if SLDs are classified as swaps and/or OTC derivatives.[6]

Regulatory treatment of derivatives in the EU sustainable finance regulatory framework

From an EU regulatory perspective, both the European Commission (EC) Delegated Act (DA) on Article 8 under the Taxonomy Regulation for NFRD-entity reporting and the European Supervisory Authorities (ESAs) final Sustainable Finance Disclosures Regulation (SFDR) Regulatory Technical Standards (RTS) report [7] exclude ESG-linked derivatives transactions from the numerator of the Taxonomy-alignment KPIs on the basis that there is not yet a reliable methodology for assessing their Taxonomy alignment, i.e., they are not recognised as contributing to Taxonomy-aligned investment activities, but include them in the denominator as part of the total assets of the product or portfolio. The view expressed is that derivatives are primarily used to mitigate counterparty risk, rather than for financing or investment, meaning that the use of derivatives in the affected products and portfolios can only ever contribute negatively to the Taxonomy-alignment KPIs.

[6] Regulatory-Considerations-for-Sustainability-linked-Derivatives.pdf (isda.org)

[7] jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf (europa.eu)

We view this approach as incorrect given that it disincentivises the use of derivatives in the affected financial products, since any exposures to derivatives could only ever contribute negatively to the Taxonomy-alignment ratio. It fails to recognise that in a sustainable finance context, derivatives are primarily used as hedging instruments, meaning they facilitate the raising and allocation of capital that is required to finance a low carbon economy transition by lowering funding costs. Moreover, the justification of this exclusion of derivatives is insufficient, as no proper impact assessment of the broader economic implications of the possible trade-off between maximising the Taxonomy ratio and the use of derivatives has been conducted to date. We believe that the exclusion of derivatives from the numerator of a green KPI while requiring their inclusion in the denominator would be sufficiently detrimental to sustainable investment strategies and to the overall goals of the UK government's Green Finance Strategy, even though adopting a different approach in the UK regulatory framework may lead to disparate disclosure requirements across major markets.[8] We would thus recommend that the calculation methodology be amended to recognise the role derivatives will need to play in securing market-based financing for Taxonomy-aligned investment activities. In a different event, we anticipate damaging impacts on the availability of funding for Taxonomy-aligned investment activities due to increased funding costs for environmentally sustainable investments in the real economy and a cooling effect on the future R&D in the ESG derivatives space, including further work on methodologies for assessing Taxonomy alignment.

On this point, we would also note that the ESAs have already indicated in their final SFDR RTS report that they might be prepared to reassess the inclusion of derivatives within the EU sustainable disclosures framework at a later stage, for example ahead of the June 2024 review of the NFRD entity reporting delegated act, once there may be more evidence in this area to allow a different conclusion. This indicates that the EU regulatory framework regarding the role of derivatives in sustainable finance is likely to remain in flux for several years, and may therefore be an inappropriate reference against which to compare parallel regulatory initiatives in other jurisdictions, including the UK.

In ISDA's view compliance with Article 8 or Article 9 requirements for financial products under the SFDR could be one option to explore for assessing the Taxonomy eligibility or alignment of derivative instruments.[9] We would also suggest this approach to be applied consistently across relevant sustainable finance disclosure requirements of the EU sustainable finance regulatory framework as differing interpretations could create investor confusion, result in fragmented outcomes and minimise the potential for evolution of risk management practices in the ESG space going forward.

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[8] ISDA Responds to EC Consultation on Taxonomy Disclosures

[9] ISDA Responds to ESAs Joint Consultation Paper on ESG disclosures under SFDR

The proposed ISDA guidance for drafting KPIs for SLDs aims to provide policymakers and regulators with useful guidance on how to assess the sustainability alignment of SLDs against relevant sustainability disclosure requirements.

In addition, as advocated by the Federation of European Securities Exchanges (FESE)[10], it is possible at present to assess the Taxonomy alignment of futures and options on single stocks, ETFs and indices because of their standardised nature and the possibility to calculate the Taxonomy alignment ratio given that the same methodology could apply as for cash instruments.

The inclusion of derivatives on both sides of the Taxonomy-alignment ratio will be of utmost importance as the regulatory environment matures. ISDA remains strongly committed to working towards the development of robust and reliable methodological approaches along with ISDA members to determine the taxonomy-alignment of exposures achieved through derivatives with a view to informing the work of UK and EU regulators in that regard.

Short-termism in sustainable investing

In ISDA's view, it is crucial to distinguish short term from short duration. An investment or a financing operation with shorter duration or lower maturity (e.g. short-term trading, liquidity management, treasury, or trade credit) should not be confused with short-termism. Investing in positions with a shorter duration could be a sound long-term strategy for investors. Short-term market liquidity is a vital factor in allowing long-term investors to value their assets appropriately, and therefore is a crucial support to long-term investment strategies. Derivatives are a tool that can support both longer- and shorter-term investment strategies, rather than an indicator of the type of strategy undertaken.[11]

It is true that the misuse of derivatives by market participants – like the misuse of any financial instrument – could give rise to short-termism. However, it is important to distinguish this from the fact that opting for highly liquid positions to gain exposure to one market segment, even when there is no underlying risk to hedge, does not prove an intent to follow a short-term strategy. Derivatives may have to be rolled or renewed, but the exposure may still be maintained over a long-term period. Moreover, all financial instruments carry the risk of loss. Thus, as long as derivatives are not misused to artificially influence pricing of the underlying asset, they cannot fuel short-termism and should not be prohibited.

This is particularly true in the context of the EU draft Ecolabel for retail financial products where the use of derivatives by retail funds is permissible only in relation to currency risk, duration risk, market risk and/or sensitivity to changes in interest rate structures. In addition, the use of derivatives to increase exposure to the underlying assets is intended to be 'temporary' and respond to significant subscriptions whereas the short selling of securities and the synthetic

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10 FESE Position Paper on the Treatment of Derivatives in the Final Draft RTS on SFDR Taxonomy-related Product Disclosures

11 ISDA Response to the ESMA Survey on Collection of Evidence on Undue Short-Term Pressure from the Financial Sector on corporations

replication in the context of passive management through the conclusion of performance swaps by ESG funds are prohibited. ISDA strongly believes that both retail and professional investors should be allowed to opt for portfolio diversification solutions that will allow them to hedge risks and/or limit trading costs through the use of derivatives. The long-term sustainability of their involvement in ESG markets is highly dependent on their capacity to hedge their positions via the use of derivatives. Therefore, investment firms are more likely to make longer-term investments if they are able to efficiently hedge the risks of such investments. Additionally, the short selling of derivatives by retail funds should not be prohibited because it is valuable to acknowledge its role in sustainable investing, in particular with a view to avoiding an outcome where short positions are not properly accounted for. For instance, synthetic replication in the context of passive management through the conclusion of performance swaps by ESG funds should clearly be an option for investors as it is primarily an optimisation strategy that is less costly for the end investor and which can bring more liquidity to the ESG underlyings.[12]

We thank you for taking the time to consider our views on these issues. If you have questions on any of the issues addressed in this letter, we are happy to discuss them with you at your convenience.

Yours sincerely,

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[12] ISDA Response to Draft Technical Report v2.0 on Development of EU Ecolabel for Financial Products

Annex

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 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 @ISDA.