ISDA® Safe, Efficient Markets

Consultation Response

CP24/8: Extending the Sustainability Disclosure Requirements (SDR) regime to Portfolio Management

14 June 2024

Executive Summary

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to the FCA's Consultation Paper on Extending the Sustainability Disclosure Requirements (SDR) regime to Portfolio Management (CP24/8).

ISDA has been a keen contributor to the ongoing discussion regarding the calibration of the regulatory framework for derivatives from a sustainability perspective and responded to the FCA's CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels in January 2023.[1]

ISDA strongly supports the FCA taking a proportionate approach to the use of derivatives in sustainable investing. In addition, we consider it important that the recommendations on the treatment of derivatives that are expected to be proposed by the EU's Platform on Sustainable Finance (PSF) by the end of 2024 are implemented consistently by the relevant authorities, including those in the UK (ISDA is an expert member of the Platform's Derivatives Workstream).

Considering this, we have some comments to share regarding the reference to derivatives on page 21 of CP24/8. In summary:

- The FCA seems to impose a criterion of intentionality - i.e. the portfolio manager's discretion - to filter which derivatives are eligible to be reported or not. Intentionality could lead to inconsistencies in reporting across different participants for similar products.

- All exposures that a fund takes on companies need to be accounted for (i.e. all derivatives that contribute to defining the cost of capital of a company and result in their CEO's decision to allocate Capital Expenditure (CapEx) to less costly/greener or more costly projects). This would ensure transparency, consistency and clarity in the treatment of derivatives and mitigate against greenwashing risks.

Detailed comments

The use of derivatives in sustainable investing

A financial instrument's contribution to sustainability can be looked at through different lenses. This could be, for example, the provision of cash through lending or direct financing (the primary market), stewardship and engagement, and derisking/ impact on cost of capital (the secondary market and derivatives).

[1] https://www.isda.org/a/GMygE/Response-to-FCAs-Consultation-on-Sustainability-Disclosure-Requirements-and-Investment-Labels.pdf

Derivatives have a role to play in sustainable finance as they contribute to liquidity, help mitigate risk, and impact the cost of capital. Derivatives are also a component of a high volume of capital-protected investment products provided to end retail investors that wish to allocate their savings towards sustainable products in line with their sustainability preferences.

Therefore, any sustainable finance framework, which should consider financial instruments holistically, should incorporate derivatives in current regulatory-defined sustainable finance metrics. Inclusion of additional disclosures on derivatives helps address product transparency and mitigates against both greenwashing and greenhushing risks.

ISDA's members' activities in derivatives are of paramount importance for their ability to answer their clients' needs both in terms of financing and investing. ISDA has been working on the contributory role of derivatives to sustainable finance and had the opportunity to provide comments on this matter to the EU's Platform on Sustainable Finance (PSF) as an expert member of its Derivatives Workstream, whose objectives were a) to provide recommendations on the inclusion of derivatives for the review of the Taxonomy Disclosures Delegated Act and SFDR and b) to ensure interoperability and consistent use of derivatives across legislations. It is important that the recommendations on the treatment of derivatives that are expected to be proposed by the PSF by the end of 2024 are implemented consistently by the relevant authorities, to avoid the inefficiencies created by divergence on the treatment of derivatives. This is also important in the context of the work of the International Platform on Sustainable Finance therein (IPSF).

On the US side, we note that the SEC Funds Names Rule, amended in September 2023, mandates that all investments of a fund on a given company/sector, whether cash or derivatives positions, must be accounted for to measure the 80% investment threshold that a fund must satisfy to comply with the Rule. Derivatives are those on equity and corporate debt measured according to their delta.

ISDA's position

ISDA strongly supports the FCA taking a proportionate approach to the use of derivatives in sustainable investing. In our response to CP22/20, we supported the FCA's proposed approach to avoid making rules specifically relating to derivatives in the first instance, and instead to monitor developments in the market and implement guidance to increase transparency around the use of derivatives in sustainable investing. We also support the FCA's final rules for asset managers, published in November 2023, which are consistent with this approach.[2] This contrasts with the EU regulatory framework, which has taken a very prescriptive approach and is likely to be subject to considerable revision over the coming years.

In ISDA's response to CP22/20, we commented on how the EU's regulatory framework provides for an inconsistent treatment of derivatives and an unclear representation of derivatives' roles in sustainability, exposing them to unwarranted claims of greenwashing. This is especially problematic for EU regulations that are already in application, such as the Taxonomy Disclosures Delegated Act, MiFID II ESG and the Sustainable Finance Disclosure Regulation (SFDR), which

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[2] Page 110 of PS23/16 states:

"…where relevant to its investment policy and strategy, firms should explain how use of derivatives and how short selling aligns with or contributes to the sustainable investment product's stated sustainability objective. For derivatives, we are not being prescriptive around how exposures should be calculated for the purposes of meeting any thresholds. Instead, firms should apply the rules based on the profile of their investment strategy and in the way that best reflects the economic and strategic reality of their exposures."

cover the use of derivatives without clear instructions on how to deal with them, either as part of a fund or when sold directly to clients.

In this latter case, the issue is of particular importance for equity and credit derivatives, which in ISDA's view can contribute to sustainability objectives based on the sustainability assessment of their underliers, proportionately to the exposure the derivative offers to these underliers. However, we believe that there should not be blanket exclusions of other asset classes which are likely to be assessed and considered in the future as new ESG objectives and methodologies develop. Overall, we would recommend the use of a look-through approach to determine the sustainability assessment of the underliers of a derivative, which would reflect standard practice allowed in prudential and other regulations. We have provided more information on the EU's work on ESG derivatives in Annex 1.

In its response to the FCA's CP22/20, ISDA confirmed that there is a pressing need for regulatory clarity on the treatment of derivatives from a sustainability perspective, and highlighted our ongoing support for development by industry of a methodology to assess derivatives so that their role in sustainability is appropriately reflected by regulation and derivatives are not subject to undue risks or penalization by regulation. More time is needed to implement derivatives disclosure given the changing regulatory landscape and the cost versus benefit of implementation. The right balance between transparency and usability/ readability to end investors should also be strongly considered. For useability purposes, a consistent approach across all relevant ESG metrics is key.

In CP24/8, the FCA mentions derivatives on page 21 as follows:

*"For assets that do not pursue the sustainability objective, the portfolio manager must identify (and disclose) assets that the portfolio invests in for reasons other than to pursue the sustainability objective**, such as cash and derivatives used for liquidity and risk management purposes**. The portfolio must not invest in any assets that conflict with its sustainability objective."*

What is inferred from this statement is that derivatives used for liquidity and risk management purposes <u>should not</u> be taken into consideration for the purpose of sustainability assessments, as they do not attain sustainability objectives. While this may hold true for certain asset classes such as FX derivatives and Interest Rate Swaps (IRS) that are not considered to have a proven real economy impact, it would also apply to equity derivatives that are frequently used as risk mitigation tools. However, as stated earlier, equity and credit derivatives may contribute to sustainability objectives as they relate to defining a company's cost of capital (i.e. the cost at which it can finance itself in the future).

Reporting all derivative positions that portfolio managers / investment managers take on companies (i.e. equity and credit underliers) would reflect the total amount of exposure or risk (or de-risking) on such companies / sectors, that contribute to decreasing the cost of capital for such activities pursued by these companies. It would also reflect the exposure for those investing in accordance with the Theory of Change, described by the FCA in its CP22/20 as 'directing typically new capital to projects and activities that offer solutions to environmental or social problems, often in underserved markets, or to address observed market failures, with the explicit aim of achieving a positive, measurable sustainability impact.'[3]

The FCA seems to impose a criterion of intentionality (i.e. the portfolio manager's discretion) to filter which derivatives are eligible to be reported or not. Intentionality is a subjective concept that is not used in any accounting standards. It can vary over time and does not play a role in the definition of the impact of a portfolio on the real economy - the only factor that defines the impact

[3] P.25 https://www.fca.org.uk/publication/consultation/cp22-20.pdf

of a portfolio is what that portfolio contains i.e. its cash and derivatives positions or trades. Further, we believe that it is not possible to control or track fund managers' intentions and, overall, using intention may lead to inconsistencies in reporting across different participants for similar products.

Reporting the full amount of risk carried out by derivatives on corporates would ensure accounting transparency, consistency and clarity in the treatment of derivatives and mitigate against greenwashing risks. We would also like to point out that the objective of the PSF's Derivatives Workstream was to look at how to account for derivatives and not to debate whether they should be included or not. We are thus of the view that all exposures that a fund takes on companies need to be accounted for (i.e., all derivatives that contribute to defining a company's cost of capital and result in their CEO's decision to allocate Capital Expenditure (CapEx) to less costly/greener or more costly projects).

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

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 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.

Annex 1 – the EU's work on ESG derivatives

The European Supervisory Authorities (ESAs), in their consultation[4] on suggested amendments to the regulatory technical standards under the SFDR, provided an indication of how derivatives should be assessed: "For this purpose, the calculation and conversion methodology set out in Article 8 and Annex II of Commission Delegated Regulation (EU) No 231/2013 is an appropriate methodology for calculating the exposure, and therefore the aggregate adverse impact, by converting the derivatives into equivalent positions in the underlying assets of those derivatives" (Recital 3).

In its response[5] to the ESAs' consultation, ISDA highlighted that the proposed conversion methodology would provide a useful reference point for assessing exposure calculations for various derivatives products. Additionally, the Securities and Markets Stakeholder Group (SMSG) highlighted in its respective response[6] that it is not in favour of an approach where derivatives are treated differently whether they relate to the degree of sustainability or to Principle Adverse Impact (PAIs) indicators.

Earlier in May, ESMA published the final report[7] containing Guidelines on funds' names using ESG or sustainability-related terms. It noted the following on the treatment of derivatives: *"The guidelines are not intended to provide a sustainability product labelling framework for investment funds. For this reason, ESMA has decided not to include any indication about provisions related to derivatives and the calculation methodologies for sustainable investments or investments used to meet environmental or social characteristics. In other words, the 80% threshold would simply be derived from the disclosures of the commitment to the proportion of investments to meet the environmental or social characteristics (under Article 8 SFDR) or the sustainable investment objectives (under Article 9 SFDR). As a consequence, the calculations for derivatives, or any other asset classes, would follow the decisions made by the fund manager under the SFDR disclosures."*

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[4] https://www.esma.europa.eu/press-news/consultations/joint-consultation-review-sfdr-delegated-regulation
[5] https://cdn.aws.isda.org/a/MyogE/ISDA-Responds-to-ESAs-on-SFDR.pdf?_zs=5CRsN1&_zl=QIbA7
[6] https://www.esma.europa.eu/sites/default/files/2023-07/ESMA22-1669215091-5374_SMSG_Advice_on_PAI.pdf
[7] https://www.esma.europa.eu/sites/default/files/2024-05/ESMA34-472-440_Final_Report_Guidelines_on_funds_names.pdf