CONSULTATION RESPONSES TO THE IIGCC DERIVATIVES DISCUSSION PAPER
Consultation responses to the IIGCC derivatives discussion paper

IIGCC published a discussion paper on incorporating derivatives and hedge funds into the Net Zero Investment Framework in May 2022 and opened it for public consultation. During the four-week consultation period, 22 written responses were received, 16 of which came from investors. Thank you to all those who contributed to the consultation.

In this document, we summarise the main feedback given during the consultation, provide our reaction to it and highlight next steps.
Key Results

- Overall, the responses are supportive of the approach laid out in the discussion paper
- The plan to include derivatives into the Net Zero Investment Framework (NZIF) was welcomed by most as was the use of the Theory of Change
- The expansion of the range of metrics to incorporate longs and shorts into gauging portfolio alignment was broadly positively received
- The proposed principles and the attention given to greenwashing were welcomed, with helpful questions raised concerning the optimal application
- There is agreement that reporting all positions (longs and shorts) is important
- Regarding portfolio measurement, views are split on incorporating shorts
- The consultation did not bring forth any new suggestions of how measures of ‘net emissions’ exposure could be used for portfolio measurement in a way that is commensurate with the achievement of net zero in the real economy.

Next Steps

We welcome the wide range of views shared during the consultation and the specific proposals made for consideration. We look forward to working with members, network partners and other stakeholders to further develop the proposal, addressing feedback so that derivatives and hedge funds may be incorporated into the NZIF.

Primarily, this involves assessing the incorporation of derivatives into the NZIF in asset classes not covered in the discussion paper.

In addition, we anticipate exploring solutions for portfolio measurement that provide full alignment with the real economy net zero objective while minimising the behavioural costs for different types of strategy.
Do you agree with the approach proposed of integrating derivatives and hedge funds into the Net Zero Investment Framework through portfolio measurement, asset alignment and portfolio management?

Overall, respondents predominantly agreed with the proposed approach of incorporating derivatives and hedge funds into the NIZF through portfolio measurement, asset alignment and portfolio management. 67% either ‘agreed’ or ‘strongly agreed’. In so doing, some emphasised the importance of accurately reflecting derivatives strategies’ scope to assist the decarbonisation of the economy.

Concerns expressed in response to this question are dealt with in more detail in the summaries of later questions, particularly:

- Excluding shorts from the definition of portfolio measurement, and;
- Providing more detail on how the proposed approach should be applied to derivatives in other asset classes.
Do you agree that the proposed Theory of Change is helpful in establishing a hierarchy of investor influence and that it matches your own broad assessment?

Overall, most responses either supported or were neutral to the adopted Theory of Change approach. Those in favour argued that it is particularly important to specify the mechanisms through which an investor can impact real world outturns when considering derivatives. In this context, there was support for the inclusion of derivatives alongside cash investments, as laid out in the Theory of Change. This acknowledges that holders of derivatives have a role to play and that there are multiple levers an investor could use.

Others agreed with the overall approach but suggested the tiers of influence could be simplified. One proposal was to combine Tiers 1 and 2, while another was to focus on financing provision / engagement / cost of capital as the relevant tiers. One respondent argued that the direct provision of operating capital should be recognised as most impactful, and that other means of influence on real economy outturns were less influential.

Those disagreeing with the approach cited different reasons. Most notable were:

One respondent argued that participation in collective engagement should be considered separately from the investment approach. In the discussion paper we recognised that even though cash share ownership carries the possibility of engagement, it does not imply that the avenues open for stewardship are actively being used. As a result, recommendations for reporting (included in Section 4) advocate explicitly drawing out an investor’s activities both in collective and individual engagements. IIGCC’s Net Zero Stewardship Toolkit provides a wide-ranging discussion on this topic.

More broadly, focusing on the difference between the ‘impact alignment’ of a strategy compared with its ‘impact generation’ is gaining attention. This is consistent with the formulation of the Theory of Change and the approach to reporting set out in the alignment section of the discussion paper.
Other feedback argued that greater attention should be given to the empirical ranking of different strategies.

The discussion paper carries evidence from a number of academic studies, while a recent article on the use of short selling to achieve ESG goals cited fifteen studies. Outliers in these fifteen studies differed by a factor of thousands in estimating the elasticity of share prices to a change in positioning. Even ignoring the extremes, differences of a factor of ten times are relatively common.

Given that these elasticity estimates do not include the effect of a change in share prices on real economy outturns, which is itself variable and dependent on the size of the company, greater precision in academic estimates would be highly beneficial to investors’ assessments of how and where to concentrate their activities. As it stands, other respondents were highly sceptical of the value of trying to attribute the carbon impact of a position.

Related to this topic, some respondents favoured new capital provision having a status of its own within the Theory of Change, with all secondary market activities subjugated relative to it. Although this was not drawn out in the responses, the logical extension of this view would be that overall, portfolio alignment categories should reserve a (presumably much) larger weight for the allocation of new capital than for investors’ other activities, whether they involve engagement or cost of capital.

NZIF recognises the importance of new capital formation through the targets investors are asked to set for ‘investment in climate solutions’. For some this is likely to be an important part of their strategies, but imposing a hard boundary seems likely to de-emphasise the contributions that can be made by other strategies, as laid out in the section on portfolio alignment in the discussion paper.

As validation for the approach taken in the discussion paper, readers may be interested to review the Theory of Change developed in the Oxford Sustainable Finance Group’s Sustainable Finance and Transmission Mechanisms to the Real Economy. For the most part, the categories presented and the broad rankings given – based on expert interviews – are similar to those in the discussion paper.

A final observation made in the responses concerned the influence of an investor’s belief on the Efficient Market Hypothesis (EMH) on the ranking of different strategies. Were a strong form of the EMH to hold, attempts to influence the cost of capital via positioning would be doomed to fail. In this event, all strategies based on secondary market transactions would be completely dominated by direct provision of capital and engagement and have no influence in the Theory of Change.

However, as implied in the consultation document, weaker forms of EMH allow for cost of capital strategies to have some influence. For certain investors this is amplified to a view that only cost of capital strategies matter, whereas for others, this appears to be an inappropriate inversion of EMH that exaggerates the relative importance of the cost of capital influence in a way that is not consistent with mainstream thinking.
For the purpose of portfolio measurement, in assessing the proposal for the definition of financed emissions incorporating derivatives, do you agree that longs should be defined by cash and derivative exposure?

Respondents predominantly agreed with the proposal that for the purpose of emissions accounting, longs should be defined by both cash and derivative exposure.

In particular, investors with derivatives-based strategies welcomed being able to incorporate their strategies into net zero commitments. Asset owners stressed the importance of a clear and consistent approach.

One respondent questioned what the treatment of derivatives positions held for risk hedging purposes should be, while another was concerned that incorporating derivatives would introduce noise into reporting.

To be consistent with the overall approach recommended in the consultation document, IIGCC’s view is that long exposure held for risk-hedging purposes should be reported separately from other long exposure, but still be incorporated into the overall assessment of emissions accounting. Doing so gives clarity to the overall impact of an investor’s strategy. Reflecting the time-weighted average of a position should also appropriately weight exposure held for hedging purposes and limit the influence of noise.
Some questioned whether positions held via index futures should be incorporated, given that the mechanism for influencing the cost of capital is highly indirect.

Given the variability of estimates of positioning on share prices, the relative influence of different types of positioning is even harder to be confident of. Intuitively, the impact of positions held in indices with relatively few constituents and a tightly defined theme is likely to be greater than those held in a large, diversified index.

Although the Theory of Change would not ascribe high influence to index positions it would be inconsistent to exclude them, just as a long only investor would include exposure to an index ETF as part of their total carbon exposure. Granularity in reporting exposure by type of instrument may allow a manager to demonstrate their influence most clearly.

Other respondents questioned the logical basis for treating shorts and longs differently.

The discussion paper sets out that the approach for treating longs and shorts depends on the context for which the reported metric is being used. The purpose of the financed emissions metric is to provide a clear basis on which the emissions associated with a portfolio can be tracked through time to be consistent with a net zero objective. As emphasised, it is not a measure of influence or a measure of risk. A portfolio evaluated as the net of longs and shorts may not converge with net zero in the real economy, making it inappropriate as a net zero metric.
For the purposes of portfolio measurement, in further assessing the proposal for the definition of financed emissions incorporating derivatives, do you agree that shorts should not be included in the definition of financed emissions?

Unsurprisingly given responses to other industry inquiries, the question of shorting split the responses like no other. This question had the most ‘strong disagreements’ of the consultation. However, a similarly-sized group of investors supported the proposal. Amongst this group there was concern that allowing shorting to be counted towards financed emissions would leave investors exposed to a charge of greenwashing, given that it is agreed by most that shorting has no/minimal impact on current emissions.

Therefore, respondents suggested that it was important to articulate, as argued in the discussion paper, that financed emissions as a portfolio measurement metric is not synonymous with the impact or level of influence of a portfolio. Some were in favour of targets on shorts being defined separately and without regard to a financed emissions metric, while others favoured isolating single company shorts from those achieved through short exposure to an index.

The disagreements with the proposal can be summarised into four main categories:

- Including longs and excluding shorts in financed emissions may misrepresent a portfolio’s exposure and impact

The discussion paper makes clear that the use of financed emissions as a metric for portfolio measurement in NZIF is neither to reflect a portfolio’s impact or exposure – these are dealt with separately in measurements of net financial risk exposure and portfolio alignment.

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1 See MSCI, ESG Reporting in Long-Short Portfolios, 2022
• Excluding shorts from consideration means that they are treated differently from a disinvestment sale

The portfolio measurement metric is designed to ensure that the adjustment of a portfolio over time is commensurate with the achievement of the net zero objective in the real economy. A measure of ‘net emissions’ does not achieve this, hence the exclusion of shorts from the proposed measurement metric.

• Excluding shorts leads to the double counting of emissions

This objection is acknowledged in the discussion paper, however, the primary objective of the NZIF is to provide a means by which investors can align their portfolios with an objective for the real economy that can be related to a scientific approach to carbon budgeting.

A metric based on longs alone can still be used for this purpose by an individual investor despite there being double counting across investors. As summarised in the discussion paper, a portfolio with a target based on the net of longs and shorts might always be ‘net zero’ on this definition, but also be associated with no progress towards the achievement of net zero in the real economy.

• Behavioural objections:

  • Excluding shorts would discourage specific strategies that could contribute to net zero, with examples given for long/short strategies and high-emitter engagement strategies

In the discussion paper, the proposed remedy for incorporating strategies using leverage is that funds reflect their exposures relative to a market benchmark, leveraged by the same proportion as the strategy itself. The challenge for strategies based on engagement with high emitters is shared by long only managers and hence not specific to those using shorts. The development of metrics that evaluate the organic reduction in emissions for a portfolio, as opposed to declines achieved by security sales, is one way of demonstrating the value from these approaches.

  • Excluding shorts would encourage the holding of long positions in sustainable names along with a short to offset the risk to inflate a fund’s claimed Article 9 status

Depending on the way in which reporting is carried out, this example might represent an additional form of greenwashing to those set out in the discussion paper. On the other hand, this example might also be drawn from a strategy emphasising the ‘cost of capital’, and hence be consistent with the approach proposed in the discussion paper. In either event, full reporting of longs and shorts helps to draw out the true nature of positioning, which is important to allow an assessment of portfolio alignment.

In addition to the feedback, a series of suggestions were given in response to the consultation. In addition to those above, the following were suggested:

  • Applying a delta-adjusted target of zero for net exposure
  • Netting of exposure within derivatives only should be allowed
  • Only physical short sales should be allowed
  • Targets on the short portion of the portfolio should be defined separately and without regard to a financed emissions metric

Notably, some of these proposals contradict one another, reflecting the diversity of views in the market, as well as the challenge of isolating short positions in cash relative to derivatives without a distinct behavioural objective.

It is important to emphasise that the approach laid out in the discussion paper strongly advocates reporting the emissions associated with shorts. Where an investor believes that a particular form of activity, e.g. physical short sales, is important to explaining their impact, adding a further layer of detail beyond that proposed would be both appropriate and desirable.

However, the discussion paper also emphasises that reporting should not misrepresent what the short position achieves. In the context of portfolio measurement, this in turn implies not including short positions to avoid giving the impression that the emissions in the underlying business have been reduced.
For the integration of shorts to be consistent with the approach set out in the NZIF for portfolio measurement, either a way to estimate the impact of shorts on current emissions would be required or it would be necessary to show how a measure of ‘delta-adjusted emissions’ could be rendered consistent with the achievement of net zero in the real economy. To date, neither of these has been established to our knowledge.
For the purposes of portfolio alignment, do you agree with the proposed approach for establishing metrics to incorporate derivatives?

More than half of respondents were in agreement with the proposed approach to developing alignment metrics to integrate derivatives into the NZIF. Some strongly agreed with the suggestion that broader metrics are needed to gauge alignment to prevent a narrow focus on portfolio emissions, and that incorporating derivatives as well as direct exposure was helpful. Overall, respondents preferred to see the same metrics for shorts as longs to increase the granularity with which a strategy could be reported.

There were two distinct strands of thinking in the responses:

- Some emphasised a preference for flexibility in the metrics used, anticipating the need for changes over time as well as the benefit of variation across different types of strategy
- Others stressed the need for simple summary metrics for allocators

Some respondents raised the question of how “climate related” should be defined. One suggested that it might encompass both decarbonization (those not transitioning) and physical climate risk (those not adapting).

In IIGCC’s view, being clear about the different impacts of strategies focusing on transition risk and physical risk is critical.

For instance, shorts focused on influencing the cost of capital for high emitters should not be conflated with those held in countries at physical risk from climate change. From this perspective, it seems clear that strategies emphasising the net zero objective should be reported distinctly from those related to adaptation and resilience.
Two specific proposals were made for metrics to be considered:

- A number of respondents suggested developing the concept of ‘net alignment’ metrics for long/short managers to facilitate aggregation of exposure across asset classes and funds.

  One specific proposal was for companies to be classified as aligned / aligning / not aligned with the weight in Net Asset Value (NAV) used to net longs and shorts in each category. The metric could then be supplemented with other stewardship metrics for engagement and voting to evaluate the overall robustness and coherence of the strategy. In general, ‘net alignment’ would be expected to vary as the investable universe changes over time. As a result, respondents observed that there would be no natural benchmark for ‘net alignment’ exposure for a long/short fund, except compared with other long/short strategies.

  Nonetheless, for managers emphasising a cost of capital strategy, a clear gradation of ‘net alignment’ exposure from ‘aligned’ to ‘non-aligned’ would be expected. Respondents made clear that this metric would be best used in combination with measures of voting decisions as a function of the carbon intensity of holdings.

  IIGCC is grateful for these suggestions and recognises that ‘net alignment’ may well be a useful metric for allocators evaluating a range of different strategies. However, we also emphasise that this metric would not eliminate or supersede the alignment targets for the long book as currently defined in the Net Zero Investment Framework.

- Proposals to avoid opportunistic labelling

  Some respondents were concerned that there might be opportunistic labelling of strategies. This concern was raised particularly in the context of short positioning given that, in some cases, the time horizon may be short, the turnover of positions high, and the potential driving factors for a position multiple. Respondents emphasised the need for fund-level information on the motivation for a strategy, and supportive evidence from stewardship to guard against this particular example of greenwashing.

  As part of its further work on the integration of derivatives, IIGCC will seek to develop ideas for alignment metrics and seek to provide clarity in developing proposals for best practice.
For the purposes of portfolio alignment, do you agree specifically that shorts may be counted towards an investor’s engagement target?

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There was general favour towards counting shorts in investors’ engagement targets, with 43% either ‘agreeing’ or ‘strongly agreeing’ and 14% ‘disagreeing’ or ‘strongly disagreeing’.

Those that agreed believed engaging is one of the modes of influence that exists for direct short positions. Although some argued that positioning was not necessarily required to participate in collective engagement vehicles, one of the merits of shorts highlighted in the discussion paper was seen as being the ability to upscale positions held in a long-biased engagement strategy. If it were the case that engagement could be conducted effectively without any position, this motivation would drop away.

Other respondents noted that it may be difficult to engage on the short side given conflicts / moral hazard. The inherent difference in the strategy and motivation for engaging for longs and shorts meant that transparent reporting of the nature of engagement is strongly advocated: gross, net, long and short metrics may all carry useful information pertaining to a strategy.

Breaking out activity as it specifically related to the Climate Action 100 was favoured by some, while others were concerned at setting a universe with too narrow a definition of the prospective companies over which a strategy might seek to have influence. A useful metric for all companies was seen as the proportion engaged directly by a manager on climate issues with clear milestones set, reported for both longs and shorts. The outright number of engagements with companies on climate-related topics over the last reporting period was similarly seen by some as valuable (both for longs and shorts).

Those who disagreed raised various concerns:

Several respondents raised the issue that shorts cannot vote, stating that the purpose of holding a short position is generally either to decrease the financial risk of holding and engaging with securities on the long side, or to raise the cost of capital.

Another respondent saw no reason as to why the list of shorts should constrain engagement opportunities. This reinforces the case for breaking out engagement activity transparently by the type of activity.
Do you agree that the proposed *de minimis* steps for all investors are appropriate for the incorporation of derivatives into a net zero strategy?

There was general opinion that the proposed *de minimis* steps were appropriate, with 42% for and 16% against.

There were relatively few comments provided on the proposed de minimis steps themselves. Of those expressing a view, one respondent emphasised the importance of transparency, questioning whether its position in the list might lead to reduced attention compared with the focus on an investor’s strategy. In the NZIF, strategy plays a key role in setting ambition for a portfolio, hence the principles reflecting that same significance. Nonetheless, as set out in the responses to other consultation feedback, transparency is critical to clear reporting of an investor’s strategy.

For those disagreeing with the proposal, one respondent suggested the inclusion of a clear caveat/acknowledgement that certain asset managers are unable to “adapt mandated activities” without the consultation and approval of their clients. Another highlighted the potential for a high level of complexity for clients and intermediaries, emphasising that implementation should be set out in detail to try to minimise these problems.
Do you agree that the proposed principles are helpful in integrating derivatives and hedge funds into the Net Zero Investment Framework?

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<tr>
<td>Strongly disagree</td>
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There was agreement that the proposed principles are helpful in integrating derivatives and hedge funds into the NZIF. 48% ‘agreed’ or ‘strongly agreed’, whilst 29% ‘disagreed’ or ‘strongly disagreed’.

Those who agreed felt the principles were helpful and grateful that IIGCC is moving the debate on the treatment of derivatives forward.

Concerns raised mostly related to objections noted elsewhere in the responses. For instance, some were worried about the additional complexity of adding derivatives to the Framework, while others were keen to ensure that the use of derivatives for the purposes of portfolio risk management was not ruled out.

One substantive proposal was to render the fifth principle (which relates to reporting) to be: “follow the money and full disclosure.” The intention was to be clear that no part of the portfolio should be immune to reporting on a given metric. The respondent’s intention was to make sure that the relative contributions of financial risk and active ownership were set out clearly, and that where alignment improvements are set out, investors should be able to identify where they come from.
Do you agree that making an explicit commitment not to engage in greenwashing in investment activities could help further a net zero ambition?

![Bar chart showing responses]

There was broad agreement from respondents to the proposal that investors should make a commitment not to engage in greenwashing in any of their activities.

However, comments made in the responses emphasised the challenges in validating such a commitment, while many were at pains to indicate that any such commitment should reinforce behaviour that is defined by legislation or by best practice reporting guidelines. Even allowing for the fact that making a commitment would not be a deterrent for those intent on greenwashing, some saw merit in doing so, given that the motivation for behaviour was hard to legislate for.

Although respondents recognised that greenwashing could be achieved with any financial instruments, some argued that because derivatives can be misused to facilitate obfuscation, best practice guidelines to produce transparency in the reporting and explaining of strategies could usefully contribute to reducing it.

Finally, respondents argued that a commitment against greenwashing should not be seen as a catch-all for loopholes not covered by recommendations, while a specific suggestion was to set out examples of greenwashing that an investor would commit not to engage in.
Do you agree that the proposed approach in this discussion document is applicable to derivatives in asset classes that are not covered?

Respondents’ clear recommendation is for the application of derivatives in other asset classes to be reviewed specifically before finalising the components to be included in the NZIF.

Respondents felt that, although understandable at one level, the discussion paper paid too much attention to shorting and too little to the potential complexities of derivatives in other assets classes.

Specific requests were made for guidance towards:

- Derivatives in sovereigns: should exposure be aggregated based on notional or DV01 exposure? Is the issuer’s commitment path to be taken into consideration in relation to the maturity of a security?
- How should the framework be applied to derivatives in interest rate swaps, CDS, FX, commodities or inflation swaps?
- Are there applications to net zero objectives for investors with vol-trading programmes or strategies such as capital arbitrage which require a different basis for evaluation?
- Whilst emissions permits are recognised as a legitimate offset in the Net Zero Investment Framework, how should derivatives on emissions permits be treated?
- How should investors engaged in insurance-linked derivative strategies report the exposure?
- How should managing sustainability-oriented funds report the use of derivatives?