ISDA. Safe, Efficient Markets

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Submitted Electronically

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-1090

Re: *The Enhancement and Standardization of Climate-Related Disclosures for Investors* [Release Nos. 33-11042; 34-94478; File No. S7-10-22]

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to submit comments on the *Enhancement and Standardization of Climate-Related Disclosures for Investors* ("**Proposed Rules**") published by the U.S. Securities and Exchange Commission ("**SEC**" or "**Commission**") on March 21, 2022.[2] The Proposed Rules are not germane to derivatives, and thus, as a derivatives trade association, we abstain from commenting on their substance. However, we would like to take this opportunity to discuss the important role derivatives can play in transitioning to a more sustainable economy and ISDA's work in this space.

From increased regulation globally to shareholder action and board-room-level focus on environment, social and governance (**"ESG"**) issues, it is clear the transition to a green economy is becoming a key issue for participants in global financial markets. Achieving this transition will require significant financing over an extended period of time, as well as comprehensive action from a wide range of participants. The financial sector as a whole, including the derivatives markets, will have a key role to play in supporting this transition by facilitating the raising and allocation of the requisite financing. Derivatives enable more capital to be channeled towards sustainable investments, help market participants hedge risk related to ESG factors, facilitate transparency, price discovery and market efficiency, and contribute to long-termism.[3]

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 970 member institutions from 77 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 depositories, as well as law firms, accounting firms and other service providers. Additional information on ISDA is available at http://www.isda.org.

[2] https://www.sec.gov/rules/proposed/2022/33-11042.pdf

[3] ISDA published a paper that discusses the role of derivatives in ESG markets and provides an overview of ESG-related derivatives products. https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf

The green transition spans multiple segments of the financial industry; and a successful transition can only be achieved if regulators are collectively aware of the aggregate roles and strategies of various actors in the financial market. In this regard, we'd like to inform the Commission of three key areas related to ESG and derivatives markets that we've been focused on: (i) developing a framework for trading in sustainability-linked derivatives (ii) clarifying the legal treatment of voluntary carbon credits, and (iii) promoting risk-appropriate capital treatment for environmentally sustainable products.

Developing a Framework for Trading in Sustainability-Linked Derivatives

Since the first sustainability-linked derivative (**"SLD"**) was executed in August 2019, market participants have entered into a variety of SLDs, mainly in Europe but more recently in Asia and the US. SLDs embed or create a sustainability-linked cashflow using key performance indicators (**"KPIs"**) that are designed to monitor compliance with ESG targets. In simple terms, they are typical derivatives transactions but with an ESG add-on that impacts payment flows.[4]

As SLDs are novel to derivatives markets, ISDA has produced two white papers covering these products.[5] The papers: identify and describe different types of ESG-linked KPIs and how they are typically being used today; provide a set of guidelines or best practices that could guide market participants in creating and drafting KPIs for SLDs; and analyze potential regulatory issues related to SLDs under US and EU regulations, respectively. ISDA is also currently conducting a market-wide survey[6] to learn more about common SLD contractual terms and determine whether there is an appetite for standardization through legal definitions and documentation.

By establishing best practices and encouraging standardization, where appropriate, to improve legal certainty, we hope to encourage participation and enhance the integrity of this developing market.

Clarifying the Legal and Regulatory Treatment of Voluntary Carbon Credits

A robust voluntary carbon market plays an important role in delivering a reliable, market-based approach for investment opportunities that reduce greenhouse gas emissions and remove carbon from our atmosphere.

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[4] We have observed that there are, generally, two types of SLDs: (1) The KPI(s) and the related impact on cashflow(s) are embedded within the derivatives transaction (e.g., a cross-currency interest rate swap (IRS) that provides additional payments, spread ratchets or a preferential exchange rate when the KPI is met); and (2) The KPIs and cashflows related to them are set out in a separate agreement that references underlying (generally vanilla) derivatives transactions for setting the reference amount to calculate the KPI-linked cashflow. The terms (including pricing) of the underlying transactions (which may include transactions with other affiliates of the parties) would generally not be affected (e.g., an agreement to make a payment if a counterparty meets its KPIs, with the payment calculated as a percentage of the notional amount of unrelated, separately documented derivatives transaction).

[5] https://www.isda.org/2021/09/07/sustainability-linked-derivatives-kpi-guidelines/; https://www.isda.org/2021/12/01/regulatory-considerations-for-sustainability-linked-derivatives/.

[6] The survey is open to both ISDA and non-ISDA members.

As a derivatives trade association, we have a strong interest in the development of a robust voluntary carbon offset market that will strengthen the functioning of the carbon credit derivatives markets and enable the continued development of liquidity in derivatives products so that market participants can appropriately manage their business risks. Facilitating trading in carbon credit derivatives that serve as hedge for climate mitigation projects will contribute to the development of deep and liquid voluntary carbon credit markets. Toward this end, ISDA is developing standardized trading templates for spot, forward, option transactions in VCCs. Such documentation is intended to assist in standardizing terms and conditions for transactions in VCCs globally, which in turn, may facilitate more trading in VCCs.

One of the obstacles to advancing voluntary carbon trading, however, is the lack of clarity regarding the legal nature of voluntary carbon credits (**"VCCs"**) across jurisdictions. Very few jurisdictions provide legal certainty about how credits can be created, bought, sold, and retired, thus making it unclear what type of security may be taken and enforced against VCCs and how that can be achieved, as well as how VCCs would be treated following an insolvency (including with regards to netting). Such determination may also have an impact on broader considerations, such as the regulatory, tax and accounting treatment of VCCs. In sum, understanding the legal treatment of VCCs is necessary to create robust voluntary carbon credit markets, which, in turn, will enable the development of a clear price signal for carbon and allow funds to be efficiently channeled towards emissions-reducing projects.[7]

Risk Appropriate Capital Treatment for Environmentally Sustainable Products

In order to further aid in the transition to a greener economy, ISDA has conducted a considerable amount of analysis to determine whether current capital regulatory standards for carbon credit certificates are appropriate. This is important for both carbon credit certificates and the broader transition to a greener economy as inappropriate levels of capital would impact the functioning of carbon credit markets and affect the willingness of institutions to invest in the green economy.

In July 2021, ISDA published a white paper analyzing the capital treatment of carbon credit trading under the Fundamental Review of the Trading Book (**"FRTB"**).[8] The paper focused on the emissions trading scheme of the EU (EU ETS) and proposed that the BCBS allocated risk weight of 60% was too conservative and suggested that a risk weight of around 37% would be more appropriate.[9] Since the publication of this paper, the European Commission published a

[7] https://www.isda.org/2021/12/01/legal-implications-of-voluntary-carbon-credits/

[8] https://www.isda.org/2021/07/23/implications-of-the-frtb-for-carbon-certificates/

[9] In April 2022, we published a supplementary paper including the results of the equivalent analysis for the US Markets which show a lower risk weight of 22% for Regional Greenhouse Gas Initiative and 13% for the Western Climate Initiative.

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proposal in October 2021 and introduced a new risk bucket for carbon credit in line with our recommendation.

Importantly, while ISDA's analysis to-date is focused on the carbon credit compliance market given the availability of data, the punitive treatment of carbon credit trading could have implications for the voluntary carbon credit market. Inappropriately high capital charges on carbon credit certificates could hamper the development of this market as well.

In addition, the emergence and anticipated growth of SLDs requires consideration to ensure appropriate capital treatment as it will play a key role in firms' decision to increase activity in this space.

Overall, we believe that the capital framework for environmentally sustainable products should be risk-based and use data evidence to inform the right calibration. Absent such an approach, punitive capital treatment or unfit financial regulation may hinder the pace of growth of environmentally sustainable products.

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Our members are strongly committed to maintaining the safety and efficiency of the U.S. financial markets and recognize that our members have a significant role to play in the transition to a more sustainable economy. We look forward to further engagement with the Commission on these important issues.

Please do not hesitate to contact me or Nicolette Cone, Associate General Counsel, [redacted] should you have any questions.

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