ISDA Safe, Efficient Markets

August 16, 2022

Submitted Electronically

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

Re: *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices* [RIN: 3235-AM96, File No. S7-17-22]

Dear Ms. Countryman:

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission **("Commission"**) on the proposed rule on *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices* (**"Proposal"**).[2] ISDA is committed to supporting the transition towards a more sustainable economy and recognizes that derivatives have an important role to play in achieving such transition. The Proposal addresses a number of issues related to the manner in which funds and advisers incorporate environmental, social, and governance (**"ESG"**) factors in to their investor disclosures, but given our role as the voice of safe and efficient global derivatives markets, our comments are limited to aspects of the Proposal that reference derivatives instruments.

Specifically, in certain cases, the Proposal requires environmentally focused funds to disclose the carbon footprint and weighted average carbon intensity (**"WACI"**) of their portfolios in their annual reports. In determining the carbon footprint and WACI of a particular portfolio, the Proposal requires the fund to assess its investments in an issuer that is engaged in activity that generate green-house gas (**"GHG"**) emissions, including its indirect investments such as derivatives. In the Proposal, the Commission excludes foreign exchange derivatives and interest

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 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.
[2] SEC Release No. 33-11068 (May 25, 2022), 87 Fed. Reg. 36654 (June 17, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-06-17/pdf/2022-11718.pdf (hereafter, Proposal).

rates swaps from this requirement, but preliminary believes that certain derivatives,[3] including total return swaps, should be included in such assessment, given that holding a total return swap creates an exposure to the underlying securities referenced in the total return swap.[4]

We support the Commission's position that interest rate swaps and other derivatives that do not reference a portfolio company should not be considered a portfolio company, as those instruments do not generate GHG emissions nor are they tied to any company that generates GHG emission.[5] We believe that all derivatives transactions (including total return swaps) should be excluded because (i) derivatives do not contribute to GHG emissions and (ii) including them in the calculation would artificially overstate a portfolio's GHG emissions, which could result in investor confusion.

While we appreciate the Proposal's limited application to derivatives transactions, the Commission nevertheless proposes that derivatives that reference a portfolio company "be treated as an equivalent position in the securities of the portfolio company that are referenced in the derivatives instrument" for purposes of the GHG metrics calculations.[6] The Proposal states that this approach "would avoid creating an incentive for funds to invest in derivatives instead of cash market investments to avoid including the GHG emissions associated with those holdings in the portfolio-level GHG metric calculations."[7] However, the Commission adopted Rule 18f-4 under the Investment Company of 1940, which limits the amount of leverage that a fund may obtain through derivatives based on the calculation of Value-at-Risk for the fund as well as for a Designated Reference Portfolio (as that term is defined in Rule 18f-4). We believe that Rule 18f-4 already adequately regulates an investment company's use of derivatives and addresses any concerns regarding an incentive for funds to invest in derivatives.

If the Commission does not wish to exclude all derivative transactions from the Proposal, it should provide calculations for determining derivatives GHG emissions. We note that such calculations should not be subjective and should not be differentiated among funds, as that would result in inconsistency across the industry. Currently, the industry is just beginning to form consensus around how to calculate emissions and assess GHG metrics for equities and sovereign bonds. There are no industry-wide standards yet covering other financial instruments, including derivatives. Market participants need time to consider how to assess and calculate emissions and GHG metrics appropriately for derivatives transactions.

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[3] In particular, the Proposal requires that any total return swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument should be included in carbon footprint and WACI disclosures.

[4] Proposal at 36680, 36751.

[5] Proposal at 36680.

[6] *Id.*

[7] *Id.*

To date, it is still unclear to us whether equity derivatives scientifically contribute to any additional GHG emissions in the underlying reference company. Related to this question, it is also unclear how "short" and "long" positions should be assessed in terms of finance emissions, or whether they should "net out" to zero. These are just some important questions that market participants need to form a consensus on before any disclosure is required. Absent reaching such a consensus, market participants may take different approaches to disclosure ultimately running counter to the Commission's policy goal of promoting standardized disclosures that enable investors to compare information across firms. At a minimum, we believe that the derivatives covered by the Proposal (i.e., total return swap, security-based swap, futures contract, or other similar instruments) should be disclosed separately, so that investors can make their own decisions as to whether they believe any open positions in derivatives scientifically contribute to GHG emissions.

In addition, we have serious concerns with the Proposal's "one-to-one" treatment of derivatives and securities for purposes of disclosure. Requiring funds to disclose the notional amount, rather than market value of their derivatives positions, may cause funds to over disclose the actual amount of its portfolio's GHG emissions. As a result, funds would appear more or less "green" relative to other funds that invest directly in ESG companies.[8] Such an approach also runs the risk of green washing as it could cause funds that do not invest in derivatives to disclose lower GHG emissions than funds that do utilize derivatives, even though the former may actually have a higher GHG emission based on its direct investments in actual operating companies. To reiterate, without a proper consistent calculation method that acknowledges the distinction between direct versus indirect investments, funds would generally be over disclosing GHG emissions, thus causing the resulting data to be unreliable for investors.

For these reasons, we urge the Commission to reconsider the Proposal as it pertains to derivatives and allow the industry sufficient time to develop standards around the relationship between GHG emissions and derivatives instruments before mandating specific disclosures.

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[8] It is also unclear to us how swaps on indices should be treated; a swap or option on an ESG index should not be treated as an equivalent position in the securities of the portfolio company.

We appreciate the opportunity to submit our comments in response to the Proposal. Our members are strongly committed to maintaining the safety and efficiency of the U.S. financial markets and recognize that the financial sector has a big role to play in the transition to a more sustainable economy. We hope that the Commission will consider our suggestions, as they reflect the extensive knowledge and experience of financial market professionals within our membership.

Should you have any questions or seek additional clarification, please reach out to me or Nicolette Cone, Associate General Counsel, at (202)-567-5782.

Sincerely,

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