# ESG DERIVATIVES

## IOSCO SURVEY

## AMAFI's answer

*AMAFI is the trade association representing financial markets' participants of the sell-side industry located in France. It has a wide and diverse membership of more than 170 global and local institutions notably investment firms, credit institutions, broker-dealers, exchanges and private banks. They operate in all market segments, such as equities, bonds and derivatives including commodities derivatives. AMAFI represents and supports its members at national, European and international levels, from the drafting of the legislation to its implementation. Through our work, we seek to promote a regulatory framework that enables the development of sound, efficient and competitive capital markets for the benefit of investors, businesses and the economy in general.*

AMAFI welcomes IOSCO's survey on ESG derivatives. Obtaining detailed insights into the current use of these financial instruments by Financial Market Participants (FMPs) will be useful to obtain an accurate picture of the current state of ESG derivatives usage and the main challenges encountered by their users.

Before answering the specific questions of the consultation, AMAFI provides hereafter a few general observations. Only the questions to which AMAFI provides an answer are listed henceforth.

### GENERAL OBSERVATIONS

Since 2021, AMAFI has actively worked with European and French regulatory bodies to promote the recognition of derivatives' role in sustainable finance[1], both as stand-alone products and as financial instruments embedded in financial products, such as in the case of ESG-structured products.

These instruments are often mischaracterised as synthetic positions incapable of contributing to sustainable finance. This mischaracterisation not only overlooks their value but also undermines their capacity to support the transition to sustainability by enabling efficient portfolio alignment with ESG objectives, as their use may impact negatively the sustainability assessment of a product or portfolio within the current regulatory framework.

[1] Several papers have been published on this topic (*AMAFI / 21-47*, *AMAFI / 23-03*, *AMAFI / 23-13*, *AMAFI / 23-54*)

Still, as acknowledged by the European Supervisory Authorities' (ESAs) in their final report on PAI disclosure under SFDR, derivatives "*also constitute investment decisions on sustainability factors*"[2].

Such recognition remains yet insufficient, at least at European level, as illustrated by the inconsistency in the treatment of these products across the regulatory framework. A global position by IOSCO on this issue would hence be very useful in overcoming current misconceptions and establishing where and how derivatives bring value to sustainability.

In its response, AMAFI focuses on key areas, including the definition of ESG derivatives (Section A.2 of the survey), the substantial challenges posed by the current regulatory regime (Section C.7), and potential steps that governments or international bodies could take to promote investor protection (Section E.19). We have chosen not to address Sections B and D, which pertain to ESG derivatives trading activity and risk management, as these are primarily based on specific entity experiences in ESG derivatives.

# I. AMAFI's ANSWERS

## 1. Scope of ESG Derivatives

AMAFI appreciates the detailed categorisation of ESG derivatives presented in the survey and underscores the need to specify their contribution according to the extent of their impact in the economy, specifically as regards investments in sustainable assets.

Since its first position paper on this topic in September 2021 (*AMAFI / 21-47*), AMAFI has consistently highlighted the role derivatives can play in sustainable finance and their various ways of contributing, including:

- **Providing exposure to sustainable assets[3]**
  - Derivatives tied to underlying assets, such as equities or bonds that are eligible or aligned with Taxonomy, offer an effective way to access sustainable investments, allowing investors to benefit from the performance of assets such as green bonds or ESG-linked equities without owning them directly.
  - By linking their value to the underlying sustainable assets, derivatives allow market participants to address sustainability objectives in a flexible and cost-effective manner, supporting broader participation and liquidity in sustainable finance.
- **Influencing investment decisions in sustainable sectors**
  - Derivatives with equity or bond underlyings serve a "signaling" function, influencing economic behavior, as they participate in price formation. Increased exposure to ESG assets

[2] ESAs, Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation, page 22, point (3), 4 December 2023.

[3] Derivatives can also provide negative exposure to ESG assets leading to disengagement. Please see more details at section I.1.ii., page 5.

can reduce the cost of capital for companies engaged in sustainable activities, encouraging further development in those sectors[4].

- This dynamic has a systemic effect by reinforcing the market's shift toward sustainability. It amplifies the flow of resources into sustainable initiatives, fostering growth in green technologies, renewable energy, and socially responsible enterprises. The indirect nature of this impact makes derivatives an integral part of the ecosystem that supports long-term sustainability objectives.

- **Supporting the implementation of sustainable investment strategies**
  - Some derivatives with no ESG underlying also play a role in faciliating sustainable investment strategies, as hedging instruments. This is the case of foreign exchange (FX) or interest rate derivatives, which help facilitate financial flows and maintaining market stability. Although they do not provide themselves exposure to sustainable assets and may not contribute to a sustainability ratio, they are  an indispensable tool to facilitate the execution of sustainable investment strategies.

- **Offering exposure with a degree of capital protection within investment products**
  - With the integration of derivatives into structured products or capital-guaranteed funds, investors can participate in equity and credit markets of sustainable assets while tailoring their risk exposure to their specific profiles.
  - As such, these instruments allow retail and institutional investors to align their portfolios with sustainability goals while maintaining risk control.

While all these contributions are important, AMAFI places particular emphasis on the significance of "ESG-underlier derivatives", as identified in the survey because these instruments provide exposure to sustainable assets. These instruments contribute to sustainable finance through the ESG characteristics of their underlying assets as detailed in AMAFI's response to the European Platform on Sustainable Finance (*AMAFI / 22-37*).

### *i. The contribution of ESG-underlier derivatives*

- **Equity and corporate bond derivatives**

The underlying assets of these derivatives must be "eligible" for ESG consideration in order to contribute meaningfully to ESG objectives by channelling capital toward entities committed to sustainable practices. Equities and credits are the only significant underlying in this regard because they represent corporates—the actors in the economy driving the transition to sustainability.

The absence of direct capital transfer to the underlying entity is often cited as the reason why derivatives are not useful to sustainable finance. However, this feature is not unique to derivatives: it is shared by all secondary market instruments. Whether in the physical cash market or derivatives

[4] Sustainability Disclosure Requirements (SDR) and investment labels, consultation paper, page 25, point 4.10, Octobre 2022.

market, transactions occur between investors and do not inject new capital into the issuing company. This dynamic applies equally to investment funds purchasing securities in secondary markets, where they acquire ownership and voting rights without directly contributing new funds to the entity. Only primary market activities facilitate the injection of fresh capital As mentioned by the FCA in the Sustainability Disclosure Requirements (SDR) and investment labels consultation paper, there are three mechanisms through which investors can contribute to positive sustainable outcomes and all of them should be considered:

- Active investor stewardship and engagement, for example through voting rights.
- Influencing asset prices and the cost of capital, for example by favoring assets with strong sustainability credentials and excluding those without.
- Allocating capital to underserved markets or addressing market failures.

Secondary markets, including derivatives, are indispensable to corporate financing. They establish asset valuations, influence pricing for primary market issuances, and ensure liquidity: they are necessary for the primary market to play its role in the first place, as without liquid secondary markets where investors know they will be able to sell their investments, they could be reluctant to invest or ask for higher prices.

- **Derivatives embedded in securities**

As regards derivatives embedded in securities, for example in structured products, they allow for more flexible investment strategies that can increase exposure to sustainable assets while managing risk. For example, by incorporating ESG-underlier derivatives, structured products can offer investors access to green bonds, sustainable equities, or other ESG-focused assets, without having to purchase the underlying securities. They facilitate greater participation in sustainable markets, especially for investors who may otherwise be unable to access or bear the full risk of such investments. Therefore, considering the exposure provided by these derivatives is important for accurately assessing the sustainability of the product, ensuring that the sustainability impact is not underestimated or overestimated, and encouraging product manufacturers to align their offerings with sustainable finance objectives.

Unfortunately, at present, the ambiguous treatment of ESG-underlier derivatives adversely impacts the recognition of the exposure component of structured products, in addition, in the EU, their exclusion from the SFDR framework limits their ability to channel funds into sustainable activities.

### *ii. Calculating the exposure provided by ESG-underlier derivatives*

Discussions surrounding the contribution of derivatives also revolve around identifying the most appropriate methodology to quantify their impact accurately. To this end, the ESAs have recognized delta as the "*the appropriate methodology for calculating exposure*" […] by "*converting derivatives into equivalent positions in the underlying assets of those derivatives*"[5]. This methodology is already in use under the Delegated Regulation supplementing the AIFM Directive[6] and the Short Selling Regulation[7] where Annex II, Part I, outlines the delta-adjusted calculation method. The approach accounts for both positive and negative exposures, providing a comprehensive view of the positions held. It is also the approach chosen by the SEC Fund Naming Rules[8].

AMAFI strongly supports the use of the delta methodology, as reflected in our responses to various consultations, including those from ESMA's on Fund Naming Rules[9], the ESAs' joint consultation on the review of SFDR's Delegated Regulation regarding PAI and financial product disclosures[10] and the European Commission Targeted Consultation on the implementation of SFDR review[11]. For ESG-underlier derivatives, delta is, in our view, the most effective method for calculating exposure to underlying shares or corporate bonds. By measuring how the value of a derivative changes with the price of the underlying asset, delta offers a clear and precise assessment of a financial institution's risk.

Other metrics, such as notional or market value, are inappropriate for calculating the contribution of derivatives. The market value or "price" of a derivative contract does not reflect the actual exposure it provides to the underlying assets. For instance, the "impact" or "responsible investment" of an investor purchasing a call option is not determined by the premium paid for the option. Similarly, the notional value of an option, which is the price of the underlying multiplied by the number of units referenced in the contract, does not indicate the economic exposure the option holder has to the underlying shares and would overestimate the impact. Therefore, relying on notional or market value would distort the calculation of exposure and fail to capture the true contribution of the ESG underlier derivative to sustainable finance.

[5] ESAs' Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation, recital (3) Draft RTS, 4 December 2023.
[6] Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
[7] Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps with regard to definitions, the calculation of net short positions, covered sovereign credit default swaps, notification thresholds, liquidity thresholds for suspending restrictions, significant falls in the value of financial instruments and adverse events. Annex II, Part I. "*Any derivative and cash position shall be accounted for on a delta-adjusted basis, with cash position having delta 1. To calculate the delta of a derivative, investors shall take into account the current implied volatility of the derivative and the closing price or last price of the underlying instrument. In order to calculate a net short position including equity or cash investments and derivatives, natural or legal persons shall calculate the individual delta-adjusted position of every derivative that is held in the portfolio, adding or subtracting all cash positions as appropriate.*"
[8] SEC Final Rule: Investment Company Names (Release No. 33-11238; 34-98438; IC-35000; File No. S7-16-22), page 275, Appendix E. "*Instruction to Item B.11: Consistent with rule 35d-1(g)(2), if the Fund uses a derivatives instrument's notional amount (which must be converted to 10-year bond equivalents for interest rate derivatives and delta adjusted for options contracts)[…]*", 20 September 2023.
[9] *AMAFI / 23-13*, reply to Q. 7.b., page 4.
[10] *AMAFI / 23-54*, reply to Q. 14, page 3.
[11] *AMAFI / 23-89*, reply to Q. 1.6, page 5.

Importantly, both positive and negative deltas should be considered in the calculation because both accurately reflects the holder's commitment or disengagement to the underlying companies. Both positive and negative delta positions should indeed be considered, as negative exposures can indicate disengagement from ESG assets, which may reduce their attractiveness to investors. This disengagement can apply downward pressure on valuations, signalling the undesirability of such assets. For example, it would be improper to net short and long derivative positions without allowing them to go below zero, as proposed by the ESAs' in their joint consultation on the SFDR Delegated Regulation on PAIs and financial product disclosures[12] (*AMAFI / 23-54*), as this would provide an incomplete picture of exposure. The significance of accounting for both long and short positions in green assets is particularly evident in the context of recent market shifts. For instance, a Bloomberg article from October 2024[13] reported an increasing number of hedge funds holding net short positions in green energy sectors such as solar and electric vehicles. This trend reflects concerns about the financial viability of green investments, despite governmental support, emphasising the need for a comprehensive understanding of the market's stance on green assets.

### *iii. ESG-adjusted derivatives*

AMAFI also recognises the potential role of "ESG-adjusted derivatives" (also known as "Sustainability-Linked Derivatives" or SLDs, according to the ISDA terminology), but notes that their current contribution is limited due to the challenges in assessing their economic impact. These derivatives typically reference underlying assets such as currencies or interest rates and primarily serve as hedging instruments. The terms of these contracts—such as payments or rates—are linked to the ESG objectives of corporate counterparties, like emissions reductions or renewable energy usage. Their main purpose is to incentivise counterparties to adopt sustainable practices and align with decarbonisation goals.

The inherent complexity and indirect impact of ESG-adjusted derivatives suggest they currently play a supportive but secondary role in advancing sustainable finance.

[12] *"Financial market participants shall net positions in accordance with Article 8(3), point (a) of that Regulation. Where the result of the netting is below zero, financial market participants shall not include this result in the "impact" column but may disclose the short positions and indicate that these short positions originate from derivatives in the column "explanation"*, ESAs' Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation', article 1 Draft RTS, 4 December 2023.
[13] Bloomberg, The Climate Short: Hedge Funds Pile Up Huge Bets Against Green Future, 21 October 2024.

## 2. ESG Derivatives Products and Markets

***7. Does the current regulatory regime applicable to ESG derivatives trading directly or indirectly encourage or, conversely, limit your Firm's use of ESG derivatives? Please briefly describe any factors that you wish to highlight about the regulatory landscape for ESG derivatives.***

As stated in our General observations, the current regime applicable to ESG derivatives creates significant challenges due to the inconsistent recognition of their role across the regulatory framework. This lack of harmonisation limits the effective use of ESG derivatives and undermines their potential to advancing sustainability objectives. This issue concerns specifically ESG-underlier derivatives, which contribution could be materialised in sustainable ratios by considering the characteristics of the underlying.

For instance, in the EU, it is currently unclear if these derivatives can be included in the numerator when calculating Sustainable Investment KPIs under SFDR. Additionally, they are penalised under Taxonomy-alignment ratios—both at the product and entity levels—where they must be included in the denominator but are excluded from the numerator.

The only ratios where their contribution can currently be quantified are those related to the PAIs, as confirmed in the ESAs' final report on SFDR[14] and previously introduced in the ESAs' Q&A on the SFDR Delegated Regulation[15].

By contrast, other jurisdictions have established frameworks where the inclusion of derivatives does not pose similar challenges. In the United States, under the SEC Fund Names Rule, derivatives are included[16] in the calculation of the investment policy of 80% of its asset value that a fund must respect[17] and must be measured according to their delta. In the United Kingdom, with regards to the Sustainability Disclosure Requirements (SDR), the FCA recognises the role of derivative as a transmission mechanism to channel capital and does not prescribe specific rules for these financial instruments. It emphasises the importance of transparency regarding their use hence implicitly mandating their disclosure[18].

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[14] "*4. For the purposes of the indicators related to adverse impacts referred to in paragraph 1, financial market participants shall include derivatives by calculating them according to the conversion method set out in Annex II to Commission Delegated Regulation (EU) No 231/2013 and applying paragraphs 4 to 9 and 14 of Annex I of that Regulation and Article 8(4) of that Regulation.*", ESAs' Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation', article 1 Draft RTS, 4 December 2023.
[15] ESAs, Questions and answers (Q&A) on the SFDR Delegated Regulation (Commission Delegated Regulation (EU) 2022/1288), 17 November 2022. Section I. Question 2.
[16] SEC Final Rule: Investment Company Names (Release No. 33-11238; 34-98438; IC-35000; File No. S7-16-22), page 78, section IV.E.3., 20 September 2023.
[17] If a fund's name suggests a focus in a particular type of investment, or in investments in a particular industry or geographic focus, the fund must adopt a policy to invest at least 80% of the value of its assets in the type of investment, or in investments in the industry, country, or geographic region suggested by its name.
[18] Sustainability Disclosure Requirements (SDR) and investment labels, "*Firms should ensure that their use of derivatives is consistent with the sustainability characteristics of the product and that they provide clear disclosures to consumers about how derivatives are used to achieve sustainability objectives*", page 110, November 2023.

Considering derivatives consistently across markets and including them in sustainable finance KPIs based on their delta would provide several benefits:

- **Encouraging broader adoption of ESG considerations**: including derivatives in these ratios would incentivise market participants to align their derivative strategies with sustainable objectives, thereby fostering greater integration of ESG considerations into financial markets.
- **Improving market efficiency:** recognising derivatives in a uniform manner would enhance transparency and comparability across products and markets, enabling investors to make informed decisions.
- **Participating to meeting sustainability objectives:** by acknowledging the contribution of ESG-underlier derivatives, regulatory frameworks would better support capital flows toward sustainable activities, reinforcing the alignment of financial products with global ESG goals.

## 3. General

***19. Please briefly describe any steps that governments or international bodies could take to promote investor protection and support fair, orderly and efficient markets for ESG derivatives.***

As mentioned in its reply to Question 7, AMAFI strongly believes that governments and international bodies should adopt a broader perspective on the types of financial products that can contribute to sustainable finance. Recognising that primary market instruments alone will not suffice to finance the transition to a more sustainable economy is essential. To support long-term transition strategies, a comprehensive approach is needed based on the effective functioning of both primary and secondary markets and adequate hedging of ESG risk.

To achieve this, governments and international bodies could in particular take the following steps:

- **Officially recognise the contribution of derivatives**
  - Sustainable finance regulations should formally acknowledge the role that derivatives—particularly ESG-underlier derivatives—can play in advancing sustainability objectives. Clear guidance on their treatment within sustainable finance KPIs, such as, in the EU, Taxonomy-alignment ratios, Sustainable Investment KPIs, and PAI metrics, would provide the clarity needed to ensure they are used for the benefit of sustainability and to incentivise FMPs to leverage these instruments effectively.

- **Encourage standardisation and harmonisation**
  - Developing standardised methodologies for quantifying the sustainability contribution of derivatives is crucial. Delta should be defined as the appropriate method for assessing exposure to ESG underlyings. A harmonised approach would eliminate inconsistencies, improve transparency, and foster fair, orderly, and efficient markets for ESG derivatives.

- **Promote education and awareness**
  - Regulatory bodies and international institutions could actively engage in educating market participants, issuers, and stakeholders about the role and potential of ESG derivatives.

Increased awareness would help clarify the purpose and benefits of these instruments, reduce mischaracterisation, and encourage their appropriate adoption in sustainable finance strategies.

- **Facilitate Innovation**
  - By providing regulatory clarity for ESG derivatives, authorities would encourage the development of innovative financial products that combine sustainability goals with effective risk management. This would expand the range of tools available to investors to invest in sustainable assets / projects and support broader participation in sustainable finance.

***20. Please share any significant articles, reports or other public sources or tools that could contribute to C7's consideration of market participants' views of ESG derivatives, such as use cases, assessments of risks and benefits, experiences with barriers to access and/or any concerns regarding investor protection considerations.***

As outlined in its General observations, AMAFI has been actively working for several years to explain the role of derivatives in sustainable finance. Our views and positions on this topic are detailed in several papers and responses to consultations. These documents offer insights into the use cases, benefits, and challenges associated with ESG derivatives, including barriers to access and considerations related to investor protection. We invite C7 to review these contributions as they also reflect the views of financial market participants in France. These include:

- AMAFI / 21-47 - Sustainable finance strategy: enabling derivatives to contribute to transition efforts.
- AMAFI / 23-03 – ESAs' call for evidence on better understanding greenwashing - AMAFI's answer.
- AMAFI / 23-13 - Guidelines on funds' names using ESG or sustainability related terms ESMA's Consultation - AMAFI's answer.
- AMAFI / 23-54 – ESAs' joint consultation on the review of SFDR's Delegated Regulation regarding PAI and financial product disclosures - AMAFI's answer.
- AMAFI / 23-89 - SFDR EC targeted consultation - AMAFI's answer.
- AMAFI / 24-85 - Listing act. Draft technical advice on the prospectus regulation and the CDR on metadata - ESMA's consultation - AMAFI's answer.

Finally, AMAFI is at the disposal of IOSCO to engage further on this topic, for e.g. through participation in any potential working group that might be established on the use of derivatives in sustainable finance. We would welcome the opportunity to contribute to these discussions and share detailed perspectives from market participants.