ISDA Safe, Efficient Markets

afme Finance for Europe

ISDA-AFME Feedback on Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks

22 August 2018

Executive Summary

ISDA and AFME support the European Commission's efforts to enhance transparency and comparability regarding low carbon and positive carbon impact benchmarks. We welcome the draft proposal for a Regulation.

ISDA and AFME believe that in order for capital to flow towards low carbon or positive carbon impact economic activities, a flexible approach needs to be taken in the development of EU low carbon and positive carbon impact benchmarks, encouraging innovation that can meet sustainability and investment goals. Many of our comments in this comment paper should be seen in this context.

We welcome the European Commission's preferred approach based on minimum standards for harmonizing the methodology associated with low carbon and positive carbon impact benchmarks, although we believe that this this preference is most clearly evident in the European Commission's draft proposal as it addresses Level 2 measures. An explicit statement supporting the principle in the Level 1 text would provide further comfort as to the eventual Regulation's compatibility with the necessity for market participants to be able to innovate and develop the market for these benchmarks.

We also believe that the proposal would benefit from greater clarity that the obligations imposed on low carbon and positive carbon impact benchmark administrators to explain their methodology relate solely to carbon emissions, and not more broadly to other ESG-related criteria.

ISDA and AFME provide a number of comments on the detail of the methodology, including the view that benchmarks administrators should be able to obtain low carbon impact and positive carbon impact benchmark designation on an optional basis at this stage, and should not be mandatorily required to do so (if falling within the low carbon impact or positive carbon impact definitions in the proposal). This would allow administrators to adapt and innovate as our understanding and technology in this area develops. We also believe that inclusion of 'scope 3' emissions should be optional at this stage (given the limitations manifest regarding the data behind such a criterion).

We note that the proposal as drafted would come into force and apply from the day following publication in the Official Journal (OJ) of the EU. We believe it would be more realistic, efficient and proportionate to allow a transition period for compliance, such that compliance would be required no sooner than 12 months after publication in the OJ of final Level 2 measures.

Benchmark methodology

We welcome measures to enhance **transparency concerning the methodologies** used by benchmark administrators, on low carbon and positive carbon impact benchmarks, and more broadly.

According to the European Commission's proposal, in addition to information already required to be disclosed under the 2016 EU Benchmarks Regulation[1], administrators of benchmarks or family of benchmarks which pursue or take into account ESG objectives would have to provide an explanation (under amendments to Article 13 and 27 of the EU Benchmarks Regulation) of how the key elements of the methodology reflect ESG factors. The Commission would be empowered to further specify the minimum content of such disclosure.

We welcome the European Commission's preferred option (among approaches considered) of introducing **minimum standards for harmonizing** the methodology to be applied to low carbon indices and 'positive carbon impact' indices. This approach supports comparability of benchmark methodologies, but also enables a degree of **flexibility** enabling benchmark administrators to innovate and develop new methodologies responding to investors' dynamically evolving needs, including their concern to invest in an environmentally responsible way.

We would welcome further clarification in the proposal of the European Commission's preference for this minimum harmonization approach in the proposed Regulation (rather than in the Delegated Acts mandated to the European Commission, in the context of which the intended minimum harmonization approach is repeated several times). An explicit statement supporting this principle in the Level 1 text would provide comfort that the proposed rules do not inadvertently introduce a rigid framework, hindering innovation.

We would welcome further certainty that these proposed amendments to the Benchmarks Regulation only apply in respect of methodologies relating to low carbon or positive impact carbon benchmarks. While this is our understanding of the intent, the proposed Regulation can be interpreted to impose requirements on administrators of low carbon or positive impact carbon benchmarks to undertake explanation of implementation of broader ESG factors in these benchmarks (Article 1.2 and 1.4 of the proposed Regulation).

ISDA and AFME also maintain some concerns about the level of disclosure that might be required under these proposals, particularly if it would entail provision of data originating from third party providers that administrators do not have permission to disclose.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=EN

Benchmark statement

Similar clarifications – in particular regarding adherence to a minimum harmonization approach (thereby enabling flexibility and innovation as the market develops) and the precise scope of explanation required by relevant benchmark administrators - would be welcome in respect of the draft provisions on **benchmark statements**. For example, would the explanation address only low carbon or positive impact carbon, or would it address implementation of ESG factors more broadly?

Low and positive carbon benchmarks definitions

ISDA and AFME welcome the proportionate scope of the proposal. In particular, the intention to focus only on low-carbon and positive carbon impact benchmarks, and on administrators already covered by the Benchmarks Regulation will, we hope, minimize costs and encourage the innovation needed to attract capital to low carbon and positive carbon impact financial instruments.

Further to the theme of innovation and flexibility, we would support clarification that benchmarks administrators should acquire low carbon impact and positive carbon impact benchmark designation on an optional basis. Such flexibility would enable benchmark administrators to keep pace – in the design of benchmarks - with advances in low carbon technologies and to adapt to evolving understanding of the means of reduction of carbon emissions. If benchmarks were required to automatically become low-carbon benchmarks or positive carbon impact benchmarks (if falling within the definition of such in the proposal) it could hinder innovation, which itself could hinder inflows to low carbon and positive carbon impact financial instruments.

Detailed considerations on methodology

Input data

In line with the 2016 Benchmarks Regulation, the input data to low carbon and positive carbon impact benchmarks should be utilized subject to a transparent and robust methodology and should originate from expert sources. Subject to these criteria, administrators should be able to benefit from some flexibility in the sources of input data.

The carbon footprint measures used by administrators should be explained in the methodology. However emissions generated by customers of a company (so-called scope 3 emissions) and avoided emissions should be optional to include at this stage, given the limitations of existing data, and the need to preserve flexibility and encourage innovation.

Further to this point, the Greenhouse Gas Protocol[2] itself challenged the application of scope 3 emissions to compare companies' emissions, in its October 2011 FAQ[3]: "The Corporate Value Chain (Scope 3) Standard is designed to enable comparisons of a company's GHG emissions over time. It is not designed to support comparisons between companies based on their scope 3 emissions. Differences in reported emissions may be a result of differences in inventory methodology, company size or structure. Additional measures are necessary to enable valid comparisons across companies, such as consistency in methodology, consistency in data used to calculate the inventory, and reporting of intensity ratios or performance metrics."

If companies' projected emissions are to be taken into account by low carbon and positive carbon impact Benchmark administrators, this should be disclosed clearly in the methodology, with projections based on widely recognized and realistic scenarios in the relevant sector.

Assets selection & weighting

Any use of carbon data to choose components and determine weighting should be accompanied in the methodology by information on:

- any thresholds used in the selection;
- whether and how carbon data impact the weighting;
- and any applied carbon momentum strategy.

This transparency would further assist investors in their evaluation of the carbon impacts of relevant benchmarks.

Non-carbon related financial criteria used for the selection of underlying elements of the index should be detailed in the methodology, as for any other benchmark covered by the Benchmarks Regulation.

Such detailed requirements might be best specified in Level 2 measures.

Exclusion principles and sector selection

We agree that criteria applied resulting in exclusion of assets or companies (for the creation for the low carbon benchmarks) and the criteria applied resulting in selection of companies (for positive carbon benchmarks) should be disclosed and explained by the administrator in order to ensure transparency for investors. However the administrator should retain flexibility in the choice of these criteria.

[2] The GHG Protocol establishes comprehensive global standardized frameworks to measure and manage greenhouse gas (GHG) emissions from private and public sector operations, value chains and mitigation actions. The GHG Protocol framework is founded on a 20-year partnership between the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD), GHG Protocol works with governments, industry associations, NGOs, businesses and other organizations.

[3] https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf

ISDA. Safe, Efficient Markets

afme/ Finance for Europe

Additional elements to consider

ISDA and AFME believe that compensation schemes via carbon emission certificates ought to be included and explained in the methodology.

We also believe that green bond benchmarks should also be in the scope of the proposed Regulation.

Disclosure of exposure of the entire carbon benchmark

The disclosure of exposure of the entire low carbon benchmark should only be optional for their administrators, as this is challenging to compute and is therefore of questionable value to investors. This would risk giving misleading information to investors and would add an unnecessary regulatory burden to administrators.

Transitional provisions

As currently drafted, the proposed amendments to the 2016 Benchmarks Regulation will come into force and apply from the day following publication in the OJ. This would mean that any administrator that produces a benchmark that falls within the definition of a low-carbon benchmark or a positive carbon impact benchmark might immediately be required to comply with the obligations in relation to methodology and the requirement to publish a benchmark statement. This would leave little time for administrators to comply with the requirements.

Similarly, if any non-EU benchmark administrators have already obtained recognition or endorsement by the time these changes come into effect, this could have an impact on that recognition or endorsement (e.g., if the relevant regulator considers that they are no longer in compliance with obligations equivalent to those under the Benchmarks Regulation).

This could be addressed by giving administrators an adequate and realistic transitional period within which to achieve compliance e.g. 12 months after publication of final Level 2 measures in the OJ of the EU.

For more information please contact jrodkiewicz@isda.org and stevi.iosif@afme.eu.

ISDA Safe, Efficient Markets

afme/ Finance for Europe

About ISDA:
Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 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 @ISDA.

About AFME:
AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe’s wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.