Response by FIA EPTA to the: EUROPEAN COMMISSION CONSULTATION ON THE RENEWED SUSTAINABLE FINANCE STRATEGY

Deadline: 15 July 2020

Introduction	The FIA European Principal Traders Association (FIA EPTA) represents 29 independent European Principal Trading Firms (PTFs) that deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of instruments, including shares, options, futures, bonds and ETFs. As market makers and liquidity providers, our members contribute to efficient, resilient, and high-quality secondary markets that serve the investment and risk management needs of end-investors and corporates throughout the EU. Our members are active participants on almost all European exchanges and platforms. Moreover, our members are important sources of liquidity for institutional investors accessing liquidity pools across Europe. FIA EPTA supports transparent, robust and safe markets with a level playing field and appropriate regulation for market participants. In 2019 FIA EPTA established a Sustainable Finance Committee for its member firms to explore how liquidity providers can contribute to the green transition. It is FIA EPTA's view that sustainable finance offers a great promise in unlocking investment capital that is essential for fighting climate change and mitigating its impact for citizens. To be widely accepted by investors, sustainable finance products need to be embedded in a healthy secondary market environment which ensures liquidity and enables investors to risk-manage their exposures. While welcoming the sustainable finance initiatives by the European Commission, challenges which FIA EPTA members encounter relate to uncertainty around

	available ESG indices and the current limited product scope which lacks a fully developed product ecosystem (consisting of underlying instruments and related futures, options and ETFs). FIA EPTA conducted a survey amongst its membership in May/June 2020. on the engagement of principal trading firms with Sustainable Finance and ESG initiatives. The FIA EPTA survey found that 76% of responding FIA EPTA members consider it important to provide liquidity in ESG related products. 46% of the respondents are already providing liquidity in ESG products and 81% are expecting to expand or to start with liquidity providing in such products. FIA EPTA is committed to supporting policymakers in ensuring the success of the sustainable finance project at all levels of the capital market ecosystem. We would welcome the opportunity to provide further background information to the European Commission on these and the other issues raised in our response.

1.5 Capital markets infrastructure

The recent growth in the market for sustainable financial instruments has raised questions as to whether the current capital markets infrastructure is fit for purpose. Having an infrastructure in place that caters to those types of financial instruments could support and further enhance sustainable finance in Europe.

Question	Draft FIA EPTA response
Question 17: Do you have concerns on the level of concentration in the market for ESG ratings and data?	FIA EPTA members do not see any concerns on the level of concentration in the market for ESG ratings and data but would like to express other concerns relating to ESG ratings and data. Please see our response to question 18.
Question 18: How would you rate the comparability, quality and reliability of ESG data from sustainability providers currently available in the market?	FIA EPTA members observe a large variety of ESG ratings in the market and would like to express its concerns on the comparability of the data. Due to the absence of standardization of ESG indicators (for example, some rating agencies might take child labour into account while others do not), there is an average correlation of .61 [‘Aggregate confusion: the divergence of ESG ratings’, Berg, Koelbel and Rigobon, 2019]). This is mainly because of measurement divergence, meaning that agencies ‘measuring the same attribute using different indicators’. Next to measurement divergence, weight, scope and aggregation of indicators play a role in the lack of correlation between the different ESG ratings. This makes it difficult, if not impossible, to come up with truly meaningful and harmonised ESG ratings between the

	different rating agencies. FIA EPTA members would like to encourage to establish more standardisation so that the comparability of these ratings increase.
Question 19: How would you rate the quality and relevance of ESG research material currently available in the market?	FIA EPTA members believe that ESG research, mainly ESG ratings, is relevant, but the quality can be improved. It is relevant because information on ESG within publicly traded companies gives the market a better understanding into what extent a company and/or portfolio is sustainable and has taken ESG factors into account. However, as described in question 18, FIA EPTA members believe that the quality (low level of harmonisation) can be improved and therefore FIA EPTA members encourage the improvement of existing data, research and ratings.
Question 20: How would you assess the quality and relevance of ESG ratings for your investment decisions, both ratings of individual Environmental, Social or Governance factors and aggregated ones?	FIA EPTA members do not take directional positions in the market and therefore the relevance of the ESG ratings is limited for our members' activity. However, FIA EPTA members believe that, when ESG ratings are reliable and harmonised, liquidity providers would have a better understanding into what extent the products they trade are sustainable and have taken ESG factors into account or not. This potentially could play a role when making the decision to start providing liquidity in a product. Looking at the market as a whole, FIA EPTA members believe that ESG ratings play a role in getting a better understanding into what extent investments are sustainable or not (this counts for individual ratings and aggregated ratings).
Question 35: Do you think the existing capital market infrastructure sufficiently supports the issuance and liquidity of sustainable securities?	**Issuance process of ESG:** The Index issuance process of ESG products is similar to other index issuance and thereby sufficiently supported, which is visible from the many ESG products launched. However, FIA EPTA members consider that the design of products requires more thought on the criteria used for the E, S, and G aspects. S and G seem more aligned, but E can be incorporated in many various ways targeting different environmental norms. **Liquidity of ESG products:** Again, in FIA EPTA members opinion the existing capital market infrastructure sufficiently facilitates the liquidity of sustainable securities. That said, the liquidity and market making support for these products is not yet at the same maturity level as for established non-ESG products. Until sufficient natural demand is built for a product, it is challenging for investment firms to provide liquidity in the product as s market makers. Given the current investor focus on ESG products, FIA EPTA members would expect there will be natural growth over time. However, to address the current "Catch-22" for many ESG products (i.e., the combination of insufficient demand and lack of a liquid market) additional steps could be considered, such as requirements on trading venues to offer more favourable pricing and market making incentives on ESG vs non-ESG products; providing incentives the buy-side

	allocate a certain percentage of AUM toward ESG products or otherwise encourage the promotion of these products to end- investors and those who allocate capital (including via favourable tax treatment for retail investors); and allowing more favourable capital and/or margin treatment for ESG products to further develop and support sell-side adoption. Finally, the entire ESG products suite needs improvement notably with improved ability for hedging ESG products in other markets via exchange traded derivatives.
Question 36: In your opinion, should the EU foster the development of a sustainable finance-oriented exchange or trading segments that caters specifically to trading in sustainable finance securities and is better aligned with the needs of issuers?	No. FIA EPTA members believe that the Commission should not seek to establish or foster a separate sustainable finance-oriented exchange category. An operationally separate market infrastructure for sustainable finance securities would unnecessarily raise barriers to entry and split market liquidity as a consequence of having to establish separate connectivity and clearing solutions. FIA EPTA members consider that this will ultimately hamper capital flows towards ESG/SME products. By contrast, we consider that to stimulate trading in sustainable finance products, it is essential to keep entry barriers for trading those products as low as possible and therefore sustainable finance products should be listed on existing exchanges. This makes them easier to trade which ultimately benefits the success of ESG products and leads to a higher likelihood of these products becoming mainstream as opposed to remaining a niche product category.
Question 37: In your opinion, what core features should a sustainable finance–oriented exchange have in order to encourage capital flows to ESG projects and listing of companies with strong ESG characteristics, in particular SMEs?	FIA EPTA members do not believe a separate exchange should be established. FIA EPTA members believe that it is important that liquidity providers are encouraged to provide liquidity in ESG/SME products. Exchanges can stimulate trading in ESG/SME products by offering attractive market-making schemes and revenue sharing schemes, including offering reduced trading fees. Issuers are instrumental in creating genuine ESG products (sometimes this is unclear, e.g. two notable ESG indices, the STOXX Europe 600 ESG-X index and the S&P 500 ESG index both carry the name ESG, but vary greatly in the number of companies excluded due to the different exclusion criteria). Issuers can stimulate trading by making management and creation/redemption fees for ESG/SME products lower compared to their non-ESG equivalent.

1.6 Corporate governance, long-termism and investor engagement

To reflect long-term opportunities and risks, such as those connected to climate change and environmental degradation, companies and investors need to integrate long-term horizons and sustainability in their decision-making processes.

Question	Draft FIA EPTA response
Question 38: In your view, which recommendation(s) made in the ESAs' reports have the highest potential to effectively tackle short-termism? Please select among the following options.	FIA EPTA members support the aim of ensuring the financial sector's contribution to the emergence of a more sustainable economy. We believe the ESAs have indeed an important role to play. We consider the options in the report to be important but would caution against introducing restrictive rules on portfolio turnover ratios or holding periods per se. High portfolio turn-over rations and short holding periods do not necessarily reflect short-termism but rather the impact of technological advancements on trading and better access to information, facilitating end-investors in more rapidly processing and responding to new information to ensure prudent risk-management. Portfolio managers have a critical role in the economic transition. Their core fiduciary duty is to achieve appropriate returns for their end-beneficiaries. Effective risk management is key for asset managers to deliver on these objectives. Introducing maximum turnover ratios or minimum holding periods would artificially reduce their ability to manage risks. In the recent COVID-19 related market downturn, such tools would likely have led to worse outcomes for end-investors. We would point to the critical information function financial markets play in providing transparency on asset pricing and risk. An effective price formation process inherently brings together market participants with different investment horizons and risk-return expectations (e.g., long vs. short). A market where investors were to be subject to minimum holding periods or maximum turnover ratios will likely be less efficient and liquidity will be rare. Finally, we would consider it an impossibly complex task to calibrate such metrics for different types of investment funds, catering to the wide diversity of investors. Therefore, we strongly caution against introducing minimum holding periods and/or maximum turnover ratios as these would not help to make the financial system more sustainable.
Question 45: Do you think that passive index investing, if it does not take into account ESG factors, could have an impact on the interests of long-term shareholders?	No, FIA EPTA members do not believe that passive index investing could have a negative impact on the interests of long-term shareholders if it does not take into account ESG factors and would not be in favour of, for instance, the introduction of regulations to require that ESG factors are taken into account. Passive index investing allows smaller, less sophisticated investors an affordable, accessible and efficient way of replicating holding a broad basket of shares/instruments and FIA EPTA members would caution against imposing any regulations that may inhibit the

	provision of passive investment instruments. It is FIA EPTA members opinion that naturally, the growing investor focus on ESG factors will result in an increased ESG classification of index instruments. FIA EPTA members disagree with the premise that passive index investing, in and of itself, could lower the incentives for long-term shareholders to participate in corporate governance matters or engage with companies regarding their long-term strategies. Although FIA EPTA members agree that a share's inclusion in an index and the creation of a passive index investment instrument on that index will result in increased indirect interest in that share, FIA EPTA members believe that long-term shareholders will have no less incentive to participate. As a general rule, FIA EPTA members would be against the introduction of any measures that may inhibit or deter active investment in European markets.

2.2 Better understanding the impact of sustainable finance on sustainability factors

While sustainable finance is growing, there are questions on how to measure and assess the positive impact of sustainable finance on the real economy. Recently, tools have been developed that can be used to approximate an understanding of the climate and environmental impact of economic activities that are being financed. Yet, an improved understanding of how different sustainable financial products impact the economy may further increase their positive impact on sustainability factors and accelerate the transition.

Question	**Draft FIA EPTA response**
Question 53: Do you think that all financial products / instruments (e.g. shares, bonds, ETFs, money market funds) have the same ability to allocate capital to sustainable projects and activities?	Yes, FIA EPTA members believe that all financial instruments have the same ability to allocate capital to sustainable projects, and activities, and would caution again a regulatory approach favouring one financial instrument type over another. We believe that ESG factors can be incorporated in all financial instruments (cash/derivative / equity-based / debt-based etc.) and do not believe that the baseline characteristics of an instrument would in any way hinder its ability to successfully allocate capital sustainably.