FIA EPTA response to the FCA Discussion Paper on Sustainability Disclosure Requirements (SDR) and investment labels

7 January 2022

Introduction
The European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the Financial Conduct Authority (FCA) Discussion Paper on Sustainability Disclosure Requirements (SDR) and investment labels (DP21/4). FIA EPTA represents 26 independent European Principal Trading Firms (PTFs) which 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 financial instruments, including shares, options, futures, bonds and ETFs. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands, and the UK (~70% of our members have been licensed by the FCA). Our members are independent market makers and providers of liquidity and risk transfer on trading venues and to end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike. FIA EPTA is committed to supporting policymakers and regulators 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 to the FCA on the issues raised in our response.

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Questions	FIA EPTA Response
Q1: What are your views on the tiered approach set out in Figure 2? We welcome views on any concerns and/or practical challenges.	FIA EPTA members agree with the tiered approach as set out by the FCA in Figure 2. Making the distinction between disclosures for consumers (disclosure layer 1) and institutional investors and other stakeholders (disclosure layer 2) is a welcome and appropriate approach aimed at what discourses are needed for each group. However, FIA EPTA members note that for useability definitions should be consistent with the existing classification in UK domestic legislation as well as with international legislation (e.g., investor vs consumer vs client).
Q2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of product than for others, please provide examples.	FIA EPTA members believe that it is important for the success of the transition to have alignment between jurisdictions. In SFDR the EU includes in its scope financial market participants and financial advisers. FIA EPTA members believe that this should also be the starting point for the UK to define the scope of new regulation and assess to which extent the scope should be amended (extended or made more narrow).
Q3: Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable and impact) and how best should we engage with them?	FIA EPTA notes the large number of (private) initiatives that have come out over time, as the demand for ESG investment was growing and a regulatory framework was not yet developed. It is an immense task to review and compare all the different initiatives. FIA EPTA members believe that the Task Force referred to in the DP should compare the different initiatives, that way, the regulator can propose consistent legislation and that it is harmonised with international regulatory initiatives, especially, and most importantly with SFDR. FIA EPTA members believe that a new ESG regulatory framework should be strong enough so that market participants do not have to use multiple other guidelines issued by a private body, guidelines should ideally only be used to supplement a regulatory framework.
Q4: Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.	FIA EPTA members agree with the FCA on the labelling and classification system set out in Figure 3. SFDR creates a good starting point and FIA EPTA members believe that alignment between the UK and EU will benefit both. If needed, the FCA is in a position to improve the new regulatory framework. However, FIA EPTA members believe that any departure from EU regulation should be explained and documented.

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Q5: What are your views on 'entry-level' criteria, set at the relevant entity level, before products can be considered 'Responsible' or 'Sustainable'? We welcome views on what the potential criteria could be and whether a higher entity-level standard should be applied for 'Sustainable' products. We also welcome feedback on potential challenges with this approach.	FIA EPTA members believe there should be a distinction between 'product level' and 'entity level'. Criteria for the 'product level' can be determined and is more stable, linking 'product level' to 'entity level' criteria creates uncertainty that a product can be ESG or not depending on the behaviour of the entity selling it. This can create uncertainty for investors on the qualification of the investment. FIA EPTA believes that recital 11 of the EU Green Bond Standard Regulation creates a basis for the continuity of ESG investments that are classified as green and will over time maybe change, this is an important mechanism to create trust and stability in ESG markets. In addition to the above, FIA EPTA members observe a large variety of ESG ratings in the market and would like to express concerns on the comparability of the data. Due to the absence of standardisation 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 rating agencies. FIA EPTA members would like to encourage the FCA to establish more standardisation so that the comparability of these ratings increases which is needed to establish mature and well functional ESG markets that have the trust and transparency end-investors need.
Q6: What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.	*FIA EPTA decided not to respond to this question.*
Q7: Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics: • intentionality • return expectations • impact measurement • additionality	As market participants, FIA EPTA members are particularly concerned with the long-term classification of Green and Sustainable contracts. Our members are committed to participating in the green transition and will commit time, money and resource into helping to build liquidity in ESG contracts not least as a part of our membership's push to not only achieve operational net-zero commitments but to gradually migrate our liquidity creation and revenue generation toward ESG impactful assets. For this reason, we are particularly interested in the "intentionality" and the "impact measurement" of the contracts we trade and ensuring that any eventual reclassification of these contracts does not adversely impact on any internal or externally mandated targets and goals.

• other characteristics that an impact product should have	
Q8: What are your views on our treatment of transitioning assets for: a: the inclusion of a sub-category of 'Transitioning' funds under the 'Sustainable' label? b: possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?	FIA EPTA members would agree with the labels set out in Question 8 but would emphasise as per Question 7 that FIA EPTA members would want to ensure that any contracts subsequently reclassified do not negatively impact performance targets.
Q9: What are your views on potential criteria for 'Responsible' investment products?	Other than the typical "green" criteria, the excellent suggestions from the FCA on the social and governance angles are welcomed by FIA EPTA members as long as they are aligned with EU criteria represented in SFDR.
Q10: Do you agree that there are types of products for which sustainability factors, objectives and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?	In FIA EPTA members view this is a very large topic but one example that would potentially impact the majority of FIA EPTA members adversely if it were misclassified is, for example, Interest Rate derivatives. It seems, to the membership, that Interest Rate contracts should be held out of any classification criteria. For argument's sake, a financial institution could use an interest rate derivative as a hedge against the financing of a non-ESG investment and it might be tempting to classify this hedging actively negatively from a sustainability perspective. Unlike an Index contract though, it would be impossible to separate "green hedges" from "brown hedges" on these instruments and they should be left neutral and unclassified/unlabelled.
Q11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?	*FIA EPTA decided not to respond to this question.*
Q12: What do you consider the role of derivatives, shortselling and securities lending to be in sustainable investing? Please explain your views.	FIA EPTA members are very pleased with this question by the FCA as FIA EPTA members believe that for the normalisation of sustainable investing it should be organised in a similar way as with traditional investment products. For now, regulators focus mainly on primary markets, however, FIA EPTA members believe that the secondary markets can play a vital role in the shift towards sustainable investing.

	For sustainable investments to function equally and grow in secondary markets, FIA EPTA members believe that derivatives, short-selling, and securities lending are integrated parts of what markets need and how they operate. **Derivatives:** FIA EPTA members believe that derivatives play a vital role in the transition and development of sustainable investments. To support this, a mature and healthy secondary markets ecosystem of exchange-traded derivatives and ETFs, based on underlying assets, needs to be developed alongside the primary and secondary market for sustainable shares and bonds. This will foster a liquid market for sustainable investment and risk management which is needed to ensure that Sustainable Finance is fully embedded into the mainstream of the financial market's ecosystem. Derivatives play an important role in mitigating price volatility, from currency fluctuations and the impact on farmers who benefit from stable prices for their products to green energy providers. FIA EPTA members believe that the listed and cleared derivatives sector are an important component in the shift towards a green economy. Derivatives products enable asset holders to manage their financial risks, which is crucial for discharging their fiduciary duty and for appropriately managing their long-term investments; thus, the listed and cleared derivatives sector is an important secondary contributor to long-termism. **Short-selling:** FIA EPTA members are aware that there is not a common understanding on the benefits of short-selling, but FIA EPTA members are convinced that short-selling is a component that is needed in well-functioning markets and that it will also improve the trust and uptake of sustainable investment. FIA EPTA members believe that new products, such as sustainable/ESG labelled products should be treated equally to established products as artificial barriers will create less trust in the market and it will be more difficult to determine the price for products that can lead to bubbles in the market. FIA EPTA members believe that short selling enables market participants to view and react upon the trust of the market in a product or asset. This is a clear function that improves transparency and makes sure that market participants can express their views on sustainable/ESG products, it provides a signal and is a component of risk management.

	The practices of short selling are also echoed by the European Securities and Markets Authority[1] (ESMA), stating that short selling is key to price discovery and market liquidity. Short selling assists with the incorporation of negative information into market prices more quickly, reducing the risk of price bubbles. The evidence suggests that restricting short selling reduces liquidity as well as significantly increases the costs of liquidity which in turn will delay and make the transition more costly. **Securities lending:** Securities lending is a part of the capital markets ecosystem, and it functions as a means of meeting settlement and collateral requirements, as well as providing liquidity and efficiency to secondary markets. Securities lending also plays an important part in price discovery and market making, as well as facilitating important hedging and investment strategies. Using securities lending can be used as a tool to reduce overall costs for investors. FIA EPTA members believe it is a useful tool in established markets, but securities lending can also support the development of sustainable investment and open up more capital that is needed for the transition. This is also illustrated by ISLA (International Securities Lending Association) in a paper published in March 2021.[2] Capital needed for the transition to net-zero and other sustainability objectives is substantial and beyond the means of public finance alone. The private investment that is needed will be critical, and well-functioning capital markets are essential to generate that funding. Securities lending plays an important role in those markets. Securities lending can help with stabilising markets and create the trust that is needed to support a smooth transition. In addition, a ban on securities lending in (sustainable) investment will not create long-termism as research by ESMA[3] showed that there was no concrete evidence for a causal connection between securities lending and undue short-term market pressures and recommend not to change policies in this area. **In conclusion**, FIA EPTA members believe that derivatives, short-selling and securities lending are components of healthy, transparent, and mature financial markets that enable end-investors to manage their risk, help with price discovery and

[1] ESMA (2019), Report on undue short-term pressure on corporations ESMA30-22-762, para. 308.
[2] March 2021, ISLA paper, ''Framing securities lending for the sustainability era'': https://www.islaemea.org/thought-leadership/framing-securities-lending-for-the-sustainability-era/
[3] ESMA (2019), 30-22-762, para. 308.

	reduce volatility. There is an inherent connection between short-selling and securities lending, the one can't occur without the other.
Q13: What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?	FIA EPTA members believe streamlining and the harmonisation of different regulations is a key component of the shift towards sustainable capital markets, it will make it easier to classify products which result in the faster uptake of sustainable investments, too many different regulatory initiatives could delay the transition.
Q14: What are your views on consumer-facing disclosures, including the content and any considerations on location, format (eg an 'ESG factsheet') and scope?	*FIA EPTA decided not to respond to this question.*
Q15: What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?	FIA EPTA members welcome the disclosures on product level including structure, content, alignment with SFDR and degree of prescription but would argue that too much reporting on products could impair the transition, the product-level disclosures should be appropriately calibrated to support the transparency of sustainable investment, it should not be a timely tick box exercise that overly complicates the readability of the discourses.
Q16: What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?	*FIA EPTA decided not to respond to this question.*
Q17: How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.	FIA EPTA members believe that is very important for different jurisdictions to collaborate and to aim for alignment of regulations. This is especially important between the UK and the EU as it is in the interest of both jurisdictions to align on this important topic. It is in the best interest of both jurisdictions to be a global standard setter. In FIA EPTA members opinion it is important for the FCA to work together with other large economic actors around the world, as it will be easier to trade sustainable investments if the regulation across jurisdictions is aligned. However, FIA EPTA members believe that it will be harder to align where there are too many different actors negotiating which can also create less effective regulation. That is why FIA EPTA members recommend that for now the UK and the EU should

	work together to create well-calibrated and robust regulations that can function as an example for other jurisdictions and maintain an open dialogue on a global level.
Q18: What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?	FIA EPTA members believe it is important for other market participants to also disclose sustainability-related information along the investment chain. FIA EPTA members do note that the information that is shared should be beneficial to the investment chain and not just a tick box exercise that will only damage the willingness of other market participants to start with sustainable investing or other sustainability efforts.
Q19: Do you consider that there is a role for third-party verification of the proposed approach to disclosures, product classification and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?	FIA EPTA members agree there is a role for third-party verification as set out in Question 19 but would emphasise as per Question 5 that for now a large variety in ESG ratings is observed which makes the comparability of the data difficult. Third-party verification is an important tool in the market to assess if investments meet criteria and works well for established investments. For ESG investments the correlation is much lower between different rating agencies. FIA EPTA members would like to encourage the FCA to establish more standardisation so that the comparability of these ratings is increased which is vital to establish mature and well-functioning ESG markets.
Q20: What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machinereadable format to better enable data collection and analysis?	*FIA EPTA decided not to respond.*