FIA EPTA
EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Exchange Traded Derivatives: Strengthening the Backbone of Sustainable Capital Markets

How ETDs can contribute to the transition towards green and sustainable capital markets

December 2023

"It is an undisputable fact that a substantial capital-raising exercise cannot be performed without the ability to hedge risks and exposures. (…) Being an efficient risk management instrument, derivatives can be channelled towards environmentally friendly investments."[1]
CEPS/ECMI

The global transition towards sustainability and net zero has become imperative due to pressing environmental challenges, such as climate change and biodiversity loss. The financial sector has to play its part via facilitating the transition towards green and sustainable capital markets that deliver on the common goals of a green economy and climate neutrality by 2050.

The European Union has taken a leadership role in creating a global baseline for regulatory initiatives to support the transition. In particular, the EU has developed a regulatory framework to enhance transparency and harmonisation in sustainable investment based on an agreed green taxonomy. As a next step, building a full capital markets ecosystem of new taxonomy-aligned investment products will be of pivotal importance.

While promising steps have been made towards facilitating such a product ecosystem, the EU's regulatory framework disadvantages the secondary markets and especially exchange-traded derivatives (ETDs) as they are not recognised for their important function in the transition.

ETDs are part of the broader market infrastructure and are important for the uptake and trust in financial markets. ETDs allow investors to hedge against these risks, ensuring the stability and long-term viability of sustainability-focused portfolios. ETDs are used by all kinds of financial market participants and are needed for the financial ecosystem to function well.

ETDs can help mitigate risks by allowing investors to hedge against risks e.g. climate-related events, such as extreme weather events.

While the Sustainable Finance Disclosure Regulation (SFDR) intends to ensure investments

[1] Lannoo, K. and A. Thomadakis (2020), "Derivatives in Sustainable Finance", CEPS/ECMI Study, Centre for European Policy Studies. https://www.ecmi.eu/publications/research-reports/derivatives-sustainable-finance

are environmentally and socially responsible, the current restriction on ETDs may inadvertently hinder progress.

Currently, SFDR would unduly disincentivise the use of ETDs in the affected financial products since any exposures to ETDs could not be counted toward the taxonomy-alignment ratio. This would make it more difficult for end-users to use ETDs for managing their financial risks and in the process undermine the goal of having safe, liquid, and efficient markets that can support the green transition.

ETDs are versatile financial instruments that can serve various purposes, including risk management and asset allocation. A mature and healthy secondary markets ecosystem of 'green' ETDs, i.e., listed futures and options, needs to be developed alongside the markets for sustainable shares and bonds.

In this regard, it is worth noting the findings of a CEPS/ECMI study on the role of derivatives in sustainable finance:

"A market that could play a significant role towards Europe's green transition is derivatives. The market has been tightly regulated since the 2007-08 financial crisis, making it safer and more transparent. (…) Moreover, they enhance the transparency and the price formation process of the underlying securities, and thus foster long-termism."[2]
CEPS/ECMI

[2] Lannoo, K. and A. Thomadakis (2020), "Derivatives in Sustainable Finance", CEPS/ECMI Study, Centre for European Policy Studies. https://www.ecmi.eu/publications/research-reports/derivatives-sustainable-finance

ETDs have a strong track record as integral components of a modern financial market infrastructure. They facilitate essential liquidity and price discovery mechanisms that underpin the efficient trading of underlying assets. In the context of sustainable investment, the liquidity and transparency brought by ETDs can attract more investors to become active in the underlying market and hence increase the availability of capital. In the case of ESG-aligned ETDs, this would include strengthening the underlying green equity and bonds markets that help fund sustainable investment projects and consequently promote taxonomy-aligned investments under SFDR.

ETDs enable investors to fine-tune their asset allocation strategies in sustainable finance.

The liquidity and trading efficiency of ETD markets can enhance the liquidity of the underlying assets. For instance, green bond futures and ESG index options provide avenues for investors to have exposure to environmentally and socially responsible investments. In addition, the existence of liquid futures contracts on renewable energy indices can attract more investors to these assets. The resulting increase in demand for sustainable assets can drive capital towards green projects and initiatives, thereby accelerating the transition to sustainability.

For now, moving investments to ESG ETDs remains hampered by fund restrictions which prevent the use of derivatives; however, ETDs could play a critical role in supporting the transition as they provide the means to hedge against the impact of climate-related events.

Financial market participants, like market makers and liquidity providers, play an important role in providing liquidity in ETDs because they connect buyers and sellers to enable the continuous meeting of supply and demand. They can be on either side of a transaction, as a buyer or as a seller. By entering and holding positions they bridge gaps between market participants, optimising trading processes; making it easier to trade and reducing transaction costs for investors. Lower costs make sustainable investments more attractive and easier to trade.

Imposing limits on the use of ETDs could stifle innovation. A more flexible approach to ETDs within regulations such as SFDR would encourage innovation that supports sustainability objectives. While SFDR intends to ensure investments are environmentally and socially responsible, the current restrictions on ETDs may inadvertently hinder progress.

ETDs should be viewed comprehensively;
ETDs are essential components of the trading infrastructure i.e. also with respect to their positive contributions to risk management and for the uptake of taxonomy-aligned investments and the green transition. With the review of SFDR by the European Commission it is time to reassess how ETDs are regarded. ETDs should be recognised by SFDR for their function in the market or should be excluded altogether; that way, ETDs can be used for risk management without having a negative impact on the Principal Adverse Impact indicators.

The unique value ETDs bring to capital markets can accelerate the transition to a more environmentally and socially responsible financial landscape.

Financial markets bring together market participants with different investment horizons and risk-return expectations. Fostering a harmonious and inclusive approach within SFDR that recognises the unique value ETDs bring to capital markets can accelerate the transition to a more environmentally and socially responsible financial landscape.

About FIA EPTA

The European Principal Traders Association (FIA EPTA) represents Europe's leading Principal Trading Firms. Our members are independent market makers and providers of liquidity and risk transfer for markets and end-investors across Europe, providing liquidity in all centrally cleared asset classes including shares, bonds, listed derivatives and ETFs. FIA EPTA works constructively with policymakers, regulators and other market stakeholders to ensure efficient, resilient and trusted financial markets in Europe.

Since 2019, FIA EPTA has been actively working with its member firms to explore how market makers and liquidity providers can contribute to the green transition. This work is supported by FIA EPTA's Sustainable Finance and ESG Committee which brings together experts from these firms. FIA EPTA actively engages with both public and market stakeholders on Sustainable Finance to support the transition toward sustainable capital markets. In 2021 FIA EPTA published Principles to showcase this commitment and monitors this with yearly member surveys.

More information about FIA EPTA and independent market makers is available on: www.fia.org/epta *and* www.wearemarketmakers.com.

FIA EPTA

EUROPEAN PRINCIPAL
TRADERS ASSOCIATION

Gustav Mahlerplein 105-115 | 27th
Floor 1082 MS Amsterdam
The Netherlands

Tel +31 20.767.1730

FIA.org/epta
epta@fia.org