FIA

ESG Futures

April 11, 2024

Reminders

- The webinar will be recorded and posted to the FIA website within 24 hours of the live webinar.
- Please use the "question" function on your webinar control panel to ask a question to the moderator or speakers.
- *Disclaimer: This webinar is intended for informational purposes only and is not intended to provide investment, tax, business, legal or professional advice. Neither FIA nor its members endorse, approve, recommend, or certify any information, opinion, product, or service referenced in this webinar. FIA makes no representations, warranties, or guarantees as to the webinar's content.*

Presenters

Host:

Michael Sorrell, Deputy General Counsel, FIA

Panelists:

Harris Kay, Partner-in-Charge, Chicago Office, Davis Wright Tremaine LLP
Elizabeth Davis, Financial Services Practice Group Co-Chair, Davis Wright Tremaine LLP
Conor McDonough, Associate, Davis Wright Tremaine LLP
Shannon O'Neil, Associate, Davis Wright Tremaine LLP

Presentation prepared by

FIA

Introduction -

Public demand and industry developments have led to increased interest in, and the creation and offering of, Environmental, Social and Governance ("ESG") futures products.

Products are offered at various futures exchanges across various sectors.

- Demand for investment and trading options related to ESG initiatives and products.
- Hedging and exposure management in ESG-driven portfolios.
- Integration of sustainability into trading strategies.

With this demand comes legal and compliance challenges.

- Numerous regulatory authorities.
- Differing priorities and guidelines.
- Attend risk factors and other pitfalls.

- Overview of Demand and Offerings
- Liquidity and challenges
- New Product Launches
- Regulatory Framework
- ESG “Buzzwords” in Fund Names
- ESMA and CFTC Cooperation
- Energy Markets and ESG Products

FIA

Demand for ESG-related Derivatives

- Eurex, a major derivatives exchange, has seen significant growth in its ESG index derivatives segment.
  - By the end of 2023, Eurex traded 11 million contracts in ESG index derivatives, with an open interest at the end of the year amounting to €5.5 billion.
  - The traded volume in 2023 grew by 5.3% to 3.2 million contracts, which included 2.5 million in futures and 680,000 in options.
- Over 1.7 million futures and more than 320,000 options on the STOXX 600 ESG-X were traded in 2023, for a notional value of EUR 35 billion, representing around two-thirds of the entire ESG segment at Eurex.
- The STOXX Europe 600 ESG-X derivatives volume now amounts to over 7% of the total in the benchmark's products.

FIA

- The EURO STOXX 50 ESG derivatives have seen significant uptake, with the volume in these contracts contributing to the growth of the ESG derivatives market.
- Eurex's ESG derivatives across Equity Index and Fixed Income total traded volume exceeded 35 EUR billion in 2022, with an Average Daily Volume (ADV) of EUR 237 million.
- By year-end 2023, the total volume of ESG Index Derivatives at Eurex increased to almost 11 million contracts, representing a total trading volume of EUR 205 billion.

Liquidity of ESG Futures: Challenges

- Liquidity concerns: Some investors are still concerned about whether the liquidity of ESG futures is strong enough to meet their needs. The E-mini S&P 500 ESG futures, for example, are the most liquid ESG futures globally, but the perception of insufficient liquidity can deter potential investors.
- Market development: ESG index derivatives are still relatively new products, and the market faces challenges in gaining wider acceptance. The development of the market is crucial for liquidity, and it requires overcoming initial hurdles related to investor familiarity and confidence.
- Liquidity distribution: As of September 2023, only about 30% of all exposure to the S&P 500 ESG Index fell into the open interest of futures. However, when it comes to liquidity, over 90% of notional value was traded through futures, indicating a concentration of liquidity in certain products.
- Sluggish adoption: There is concern over the slow adoption of ESG futures, which can impact liquidity. While liquidity in ESG equity futures is considered "pretty good," the pace of growth and adoption is not as rapid as some market participants would like.

FIA

Liquidity of ESG Futures: Opportunities

- Growth in trading volumes: The E-mini S&P 500 ESG futures contract has seen growth in both average daily volume (ADV) and open interest (OI), with an ADV for 2021 of about 1,000 contracts per day and an OI of just over 14,000 contracts. This growth indicates a positive trend in liquidity.
- Mainstream acceptance: Volume development shows that ESG solutions in benchmark derivatives have become more mainstream. Eurex, for example, traded 11 million contracts in ESG index derivatives by the end of 2023, with an open interest of €5.5 billion. The traded volume in 2023 grew by 5.3% to 3.2 million contracts.
- Increasing sophistication: Investor appetite for a wider range of increasingly sophisticated ESG index derivatives is latent. As the market grows and more products are offered, liquidity is expected to improve.
- Positive multiplier effect: Each new client allocating to ESG products has a positive multiplier effect, increasing both the OI and the liquidity of the product.
- ESG ETFs and liquidity ecosystem: The S&P 500 ESG Index has seen a growing network of financial products based on it, including ETFs, futures, and options, which contribute to the liquidity ecosystem.

FIA

- There are concerns over latent investor appetite for a wider range of increasingly sophisticated ESG index derivatives. Here is what we know:
  - Eurex, a derivatives exchange, has seen a growth in traded volume of ESG index derivatives, with a 5.3% increase in 2023, reaching 3.2 million contracts. This includes 2.5 million in futures and 680,000 in options.
  - The open interest at Eurex for ESG index derivatives at the end of 2023 was €5.5 billion.
  - Since its development of the first ESG product in 2019, Eurex now offers a range of 38 equity and index futures products and two fixed income products.
  - Eurex has traded a total of 11 million contracts in ESG index derivatives.
  - A broad member base is actively using Eurex's ESG index derivatives, with banks and market makers providing liquidity for trading on screen or via the exchange's trade entry services

New Product Launches

- Issuer: CME Group
- Launch: The E-mini S&P 500 ESG Index futures have been part of CME Group's offerings, tracking the S&P 500 ESG Index. This product has seen a significant increase in trading volumes, indicating its popularity among investors
- Features: These futures are based on the S&P 500 ESG Index, which applies ESG criteria to the constituents of the S&P 500 Index, excluding companies based on their ESG performance. This product offers investors a way to gain exposure to a broad range of ESG-compliant companies within the S&P 500

- Issuer: Intercontinental Exchange, Inc. (ICE)
- Launch: Recently, ICE expanded its equity derivatives complex with the introduction of MSCI Index Total Return Futures (TRFs). These TRFs offer exposure to MSCI's flagship indices, including the MSCI EAFE Index and MSCI Emerging Markets Index
- Features: The TRFs serve as an exchange-listed alternative to over-the-counter total return swaps, providing investors with a more transparent and regulated way to gain exposure to global ESG indices.

Socially Responsible Investing (SRI) Indices Futures

- Issuer: Eurex
- Launch: In January, Eurex expanded its equity-index linked product suite by introducing futures on Socially Responsible Investing (SRI) indices covering Europe, US, World, and Emerging Markets
- Features: These futures are designed to meet the growing demand for advanced ESG methodologies, allowing investors to gain exposure to companies that meet specific social responsibility criteria

- Issuer: Eurex
- Features: Among the most liquid products offered by Eurex, these futures generate a significant portion of total ESG volumes traded on the exchange. They provide a diversified ESG solution close to the STOXX Europe 600 index.

FIA

Regulatory Framework

United States

- Diverse Regulatory Landscape: The U.S. features a patchwork of state-level ESG regulations, with some states adopting "anti-ESG" measures and others promoting "pro-ESG" policies.
- Federal Oversight and Initiatives: At the federal level, agencies like the SEC are considering rules to enhance transparency and combat greenwashing in ESG investing.
- State-Level Actions: States have enacted laws to either restrict or encourage the use of ESG factors in investment decisions, reflecting a politically divided approach to ESG.
- Impact on Asset Managers: Anti-ESG laws in some states require investment decisions to focus solely on financial returns, affecting asset managers and their ESG investment strategies.

Europe

- Corporate Sustainability Reporting Directive (CSRD): A key regulation in Europe, aiming to enhance ESG reporting standards across EU member states, with phased application based on company size.
- Sustainable Finance Disclosure Regulation (SFDR): Mandates sustainability reporting for investment managers, aiming to increase transparency in ESG integration into investment decisions.
- EU Taxonomy Regulation: Establishes a classification system for sustainable activities, promoting investments in sustainable projects and addressing greenwashing concerns.
- EU's Green Deal and Sustainable Finance Plan: Frameworks aimed at financing the transition to a sustainable economy, including the European Green Bond Standard (EUGBS) and amendments to the EU Taxonomy.
- Impact on Financial Institutions: FSIs in the EU must publish their Green Asset Ratio (GAR) as a new KPI, measuring the proportion of assets aligned with the EU Taxonomy.

FIA

General Points

- Global Influence of EU Regulations: The EU's regulatory push is expected to influence global markets, with more countries likely to introduce similar ESG regulations.
- Challenges and Opportunities: The evolving regulatory landscape presents both challenges in compliance and opportunities for innovation in sustainable finance.
- Need for Internal Expertise: Companies must develop internal expertise to navigate the changing regulations and distinguish between genuine sustainability efforts and greenwashing.
- Investor Adaptation: Investors will need to shift from relying solely on ESG ratings to conducting comprehensive fundamental analyses of companies' sustainability efforts.

ESG-related Terms in Fund Names

ESMA's Monitoring of ESG-related Terms in Fund Names

- 400% Increase in ESG Language: ESMA found a 400% increase in the use of ESG-related terms in fund names over the past ten years, indicating a significant rise in ESG-focused investment products.
- Investor Protection Focus: ESMA's efforts are aimed at ensuring that the use of ESG terminology in fund names does not mislead investors, emphasizing the importance of transparency and investor protection.
- Challenges for Investors: The prevalence of generic ESG terms in fund names poses challenges for investors in verifying the alignment of fund investments with ESG claims.
- In December 2023, ESMA published a statement updating its plans for the adoption of guidelines on funds’ names using ESG or sustainability-related terms to include additional criteria for funds using “sustainable” or related terms in their names and introduces requirements for funds that use the word “transition” or related terms in their names. A fund using the word “impact” or ESG-related terms in its names must meet the minimum proportion of 80% of investments that meet the sustainability characteristics or objective.

FIA

- <u>Preventing Misleading Use of ESG Terminology</u>: The SEC has adopted amendments to the "Names Rule" in the Investment Company Act to address the potentially deceptive use of ESG terminology in fund names, aiming to enhance clarity and prevent greenwashing.
- Typically, a fund's name is the first piece of information that investors receive about a fund. The amendments will require more funds to adopt a policy to invest at least 80 percent of the value of their assets in those investments, including funds with names suggesting a focus in investments with particular characteristics like "growth" or value" or certain terms that reference a thematic investment focus, such as the incorporation of one or more environmental, social, or governance factors.
- The SEC noted that funds with ESG-related terms in their names such as "sustainable," "green," and "social responsible" to suggest an ESG focus present challenges because approaches to ESG investing vary and with evolving investor expectations around terms like these compound the possibility of investor confusion and potential greenwashing in fund names.
- There has been an increase in SEC enforcement actions in the ESG and anti-greenwashing space and in 2021, the SEC's Division of Examination published a risk alert related to claims of investment advisers and investment funds about ESG investing.

FIA

ESMA and CFTC Cooperation

ESMA and CFTC Cooperation

- Memorandum of Understanding: ESMA and the U.S. Commodity Futures Trading Commission (CFTC) have entered into a memorandum of understanding regarding cooperation on central counterparties, which could have implications for the oversight and regulation of ESG futures.
- Impact on ESG Futures: This cooperation may lead to more harmonized regulatory approaches and standards for ESG futures, fostering cross-border collaboration in sustainable finance.

FIA

CFTC's Proposed Guidance on Voluntary Carbon Credit Derivative Contracts

- Setting Standards for Carbon Credit Derivatives: The CFTC is moving to establish standards for voluntary carbon credit derivative contracts, aiming to improve transparency, accurate pricing, and market integrity.
- Fostering Market Integrity: The guidance seeks to ensure that the voluntary carbon markets operate in a manner that supports the integrity of ESG futures and contributes to the broader goals of environmental sustainability.
- Comment period closed earlier this year.
- The proposed guidance proposes that DCMs must:
  - List only derivative contracts that are not readily susceptible to manipulation;
  - Monitor a derivative's contracts terms and conditions as they relate to the underlying commodity market; and
  - Satisfy the product submission requirements under Part 40 and Regulation 5c(c).

FIA

- The proposed guidance also provides that the voluntary carbon credit commodity contract should consider quality standards.
- The proposed guidance also addresses transparency, additionality, permanence, risk of reversal, and robust quantification.
- We can expect to see the CFTC’s enforcement division enter the fray in the area while this proposed guidance is being considered and the Commission continues to gather more information on climate-related financial risks. This past year, the CFTC established a new Climate Risk Unit and issued an environmental fraud task alert.
- The CFTC’s Whistleblower Officer also issued an alert seeking whistleblowers connected to fraud or manipulation in the voluntary carbon market, highlighting the particular areas of wash trading, the use of ghost carbon credits double counting credits, fraudulent statements in relation to the carbon credit market, and manipulation of tokenized carbon markets.

Energy Markets & ESG Products

Regulatory Compliance

- The energy landscape is shifting, and ESG factors are playing an increasingly important role in shaping the industry.
- Understanding the ESG disclosure and reporting requirements relevant to energy companies is crucial because this reporting directly impacts how ESG futures are valued and perform.
- For example, disclosure requirements for greenhouse gas emissions—e.g., the SEC's new rules regarding what information companies must disclose about their emissions and climate risks—or corporate diversity metrics may influence the pricing of ESG futures contracts.

Impact of ESG on Energy Financing

- A company's ESG performance may directly affect its access to capital.
- When it comes project development, particularly for the sort of large-scale infrastructure (e.g., transmission projects) necessary to support the energy transition, capital is king.
- Companies with strong ESG credentials may receive lower interest rates, impacting the overall cost of production and potentially influencing futures pricing.

FIA

Legal Risks and ESG

- There are significant legal risks associated with companies misrepresenting their ESG performance. This can lead to lawsuits and erode investor confidence in the entire ESG futures market.
- Companies should employ best practices to ensure their ESG data collection and reporting is transparent, verifiable, and avoids unnecessary legal risk.
- Best practices include compliance with both company-specific processes (e.g., data governance and verification, employee training, stakeholder engagement) and industry standards and requirements (e.g., standardized metrics, regulatory regimes).

FIA

- The global energy transition towards renewable sources like solar and wind power is reshaping market dynamics. The growth in these markets is remarkable and shows no sign of slowing down anytime soon.
- This creates tremendous opportunities for the development of new ESG futures products that reflect this shift, such as renewable energy certificates futures or carbon capture technology futures.
- One evolving market to keep an eye on is the market for tax equity credits generated as a result of a renewable power installations. The Inflation Reduction Act enabled the transferability of these tax incentives for the first time, enabling a nascent and growing market.

Voluntary Carbon Markets

- There's been significant activity in the voluntary carbon markets over the past several years, including a ballooning number of carbon certification standards.
- From a markets perspective, this raises questions regarding whether it would be more valuable to encourage coalescence around fewer, more robust standards. Standardization and verification of carbon credits will inherently influence the development and pricing of carbon-related ESG futures contracts.
- The CFTC—in moving to establish standards for voluntary carbon credit derivative contracts—is seeking to inject the standardization necessary to promote the transparency and liquidity of these products.
- Notably, however, although the CFTC has enforcement authority over fraud and manipulation in the spot voluntary carbon credit market, it doesn't have regulatory authority over the spot trading of voluntary carbon credits.

Climate-related Financial Disclosures

- The SEC approved new rules in March regarding the information companies are required to disclose about their greenhouse gas emissions and climate risks, but dropped the more stringent requirements (i.e., Scope 3 reporting) initially proposed by the Commission.
- The new SEC rules—although not as strong as existing climate disclosure regulations in California (i.e., the Climate Corporate Data Accountability and Climate-Related Financial Risk Acts) and the EU (i.e., the CSRD), where many multinational corporations do business anyway—require significantly increased climate transparency.

FIA

Climate-related Financial Disclosures (cont'd)

- Under the SEC framework, companies have two primary obligations:
  - Emissions reporting - large accelerated filers and accelerated filers have to report their Scope 1 and 2 emissions
    - **Scope 1** = direct emissions that are owned or controlled by a company
    - **Scope 2** = emissions that a company causes indirectly and come from where the energy it purchases and uses is produced
    - **Scope 3** = emissions created by a company's value chain
  - Climate risk disclosures – requires analysis of organization's climate-related material risk
- These disclosures can influence the valuation of ESG futures contracts by providing investors with more comprehensive information about a company's sustainability practices and potential climate-related risks.

FIA

- If executed well, international efforts like the MOU between ESMA and the CFTC on harmonizing regulations for ESG futures across different jurisdictions will ideally create a more stable and efficient global market for ESG futures.
- It's worth noting, however, that there is inherent tension due to the politicization of ESG in the US—which has a relatively smaller share of the global market for sustainable assets—versus Europe.

Greenwashing Concerns

- Accurate and transparent ESG reporting is critical for maintaining investor confidence in the credibility of ESG futures.
- In addition to the SEC's "Names Rule," the EU recently approved legislation applicable to multinational corporations that bans exaggerated and unfounded claims and in consumer marketing and ESG/ sustainability reports.
- As the regulatory regimes evolve, greenwashing claims are being litigated with greater frequency, particularly with regard to voluntary disclosures, representations regarding the integrity of products and supply chains, and internal DEI policies.

Innovation in ESG Derivatives

- Acknowledging the risks, there is significant potential for innovation in ESG derivatives within the energy sector, including the development of new instruments that cater to specific sustainability goals.

FIA

Thank you for joining us today!

Upcoming Webinar:

Enforcement & Technology: Prevent & Manage Technology Investigations?
10:00 – 11:00 AM ET

FIA

FIA