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17 June 2022

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Programme Officer
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Re: Incorporating Derivatives & Hedge Funds into the Net Zero Investment Framework

Dear Mr. Turner,

The Standards Board for Alternative Investments (SBAI) welcomes the opportunity to provide input to the IIGCC Discussion Paper on "Incorporating Derivatives & Hedge Funds into the Net Zero Investment Framework" (Herein after referred to as the "IIGCC Discussion Paper"[1]).

At the SBAI, we are an active alliance of over 150 asset managers and over 90 institutional investors dedicated to advancing responsible practice, partnership and knowledge. Our community includes asset managers with over $2 trillion in AUM and institutional investors responsible for over $5 trillion in assets. We aim to improve industry outcomes through our Alternative Investment Standards[2], practical industry guidance[3] and engagement with the global regulatory community[4]. Our mission is to bring asset managers and investors together to achieve new best practices and improve industry outcomes.

The area of responsible investment has been a core focus for us here at the SBAI, with a large working group with over 170 representatives from both institutional investors and asset managers contributing to our efforts. Through this group, we have spent significant time discussing how responsible investment considerations apply in different alternative investment strategies including Long Short Equity, Macro, Credit, Systematic, and ILS[5]. We believe that alternative investment managers can play a significant role in helping drive the transition to net zero, and our resources help both investors and managers work towards this, accounting for the diversity of strategies and instruments in the alternative investment industry.

The IIGCC Discussion Paper seeks to support investors' commitment to achieve net zero by helping drive emission reduction in the real economy. The framework seeks to provide the analytical foundation for incorporating derivatives and short selling in the context of equity and credit markets.

Overall, we agree that position weighted gross long, gross short, and net emission metrics should be reported to enable investors to make well informed investment decisions for both, risk management and net zero materiality purposes. We note that there is significant disagreement about whether reporting of net emissions is a relevant metric under "Net zero measurement and alignment".

[1] https://www.iigcc.org/resource/derivatives-and-hedge-funds-discussion-paper/
[2] Alternative Investment Standards: https://www.sbai.org/standards.html
[3] SBAI Toolbox: https://www.sbai.org/toolbox.html
[4] SBAI Regulatory Engagement: https://www.sbai.org/regulatory-engagement.html
[5] SBAI Responsible Investment Guidance: https://www.sbai.org/toolbox/responsible-investment.html

However, at this stage, we believe there is no basis for establishing a norm or standard <u>not allowing</u> net emission metrics as a tool, for example for aggregation purposes, under the "Net zero and alignment metrics".

In this response we would like to raise three key concerns with the IIGCC Discussion Paper as it stands:

- The distinction between Risk Materiality and Net Zero Materiality is too simplistic to cover the range of approaches to carbon emissions. This split appears to form the basis of the exclusion of short positions from the Net Zero Materiality metrics. We believe this simplistic split ignores the practical use of short positions in the transition to net zero and therefore does not give investors the full information to make informed investment decisions.
- The framework advocates for partial transparency by recommending the exclusion of short positions in certain metrics. We are supportive of full and clear transparency to investors. We believe that mandating partial transparency could increase the risk of greenwashing (even where unintended by the asset manager) as it does not provide a complete picture of the holdings.
- Benchmarks – the exclusion of shorts is in some way justified by the concern that asset managers may use their short positions to "offset" their long carbon emissions and therefore appear to beat the target that is set as at or below the long-only baseline index. We believe the issue here is not the inclusion of short positions but the choice of benchmark and we discuss this further below.

We would be supportive of all metrics (excepting those related to voting which would only be applicable to long cash positions) to be reported as follows:

Long Cash Positions	A
Long Derivative Positions	B
Total Long Positions	**C = A + B**
Short Cash Positions	D
Short Derivative Positions	E
Total Short Positions	**F = D + E**
Net Total	**C - F**

Reporting metrics this way gives investors full transparency into reported emission numbers including whether the holdings are direct or indirect and clearly shows the inputs for the calculated gross and net numbers. Reporting this way also allows institutional investors to aggregate the data in a way that makes sense to their own specific objectives.

The remainder of this letter includes more detailed observations on:

- Theory of Change and Tiering Approach
- Distinction between Risk Materiality and Net Zero Materiality
- Shorting and Net Zero
- Netting for the purposes of calculating Financed Emissions
- Partial Transparency Concerns
- Benchmarking and Targets

Theory of Change and Tiering Approach

The starting point for the assessment are the carbon emissions that can be attributed to the universe of all issued stock and bonds – the carbon exposure of the market portfolio. We agree with the IIGCC approach that there are different ways investors can influence the reduction of these carbon emissions i.e., the "Theory of Change", described in the IIGCC Discussion Paper that:[6]

- Tier 1: Supplying new capital with positive impact.[7]
- Tier 2: Voting/engagement/stewardship with positive impact
- Tier 3: Positive impact through market pricing mechanism, the buying or selling of assets with differing carbon intensities[8]

We strongly agree that the tiering does not represent a "ranking" of the materiality of each transmission mechanism. **We would like to particularly highlight the importance of Tier 3 in this Theory of Change**. Whilst Tier 1 and Tier 2 impacts are only active in some instances (e.g., new capital being issued (Tier 1) or investors exercising voting rights on eligible securities on carbon related matters (Tier 2)), Tier 3 impact through market pricing occurs in all instances that assets are traded, regardless of whether they are bought or sold, or the instrument type traded.[9] Therefore, the Tier 3 impact, which is often dismissed in net zero discussions, is a very relevant and strong method of influence. It is permanently present in actively traded markets with sophisticated market participants. The Theory of Change and in particular the importance of Tier 3 impact informs many of our comments below including those where we believe the proposed methodology is not consistent with this Theory of Change.

Distinction between Risk Materiality and Net Zero Materiality

Throughout the discussions in our Responsible Investment Working Group, we have identified at least three different ways that investors think about carbon emission exposure in their portfolios:

1. The risk of exposure to carbon – e.g., from carbon taxes or a rapid transition to a low carbon world,
2. Carbon emissions in the economy overall including strategies aimed at driving the net zero transition, and
3. Carbon emissions within one specific portfolio (i.e., an investors carbon responsibility).

The IIGCC Discussion Paper, in contrast, makes the distinction between **"Risk Materiality"** and **"Net Zero Materiality".** This groups the last two of these points into one concept of "Net Zero Materiality", when the metrics and information required to assess these objectives can be different.

Risk Materiality correctly allows netting of long and short positions to show the net portfolio exposure to carbon net financial risk – i.e., is treating in the same way as any other financial risk factor.

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[6] As set out on page 15 in the discussion paper: Theory of Change: How investors create influence

[7] It could be argued that Tier 1 impact should be subsumed under Tier 3, as "not funding" particular projects will on average increase their cost of capital (but not necessarily prevent such projects, or prevent their negative externalities/carbon emissions), and funding projects with positive impact will reduce their cost of capital and help reduce carbon emissions.

[8] Note: Along the same lines, selling an asset to another investor has no impact on aggregate carbon emissions, only on pricing of the asset (Tier 3).

[9] Putting Tier 1 vs. Tier 3 impact into context: Comparison of size of primary vs. secondary markets for London Stock Exchange: New Issuance & IPOS (2021): Total Raised: GBP 15.3BN, versus value traded (all markets, 2021): GBP 1,248.5bn. Note: Not all of the issuance is necessarily having positive (Tier 1) impact.

The proposed **"Net Zero Materiality"** is defined as *"measuring and managing real economy net zero alignment objectives",* with *"metrics based on the full range of an investor's strategies to influence the trajectory of future emissions"*.[10] The starting point for this approach accounts only for long cash or derivative positions but excludes short positions. The rationale for this is made in various statements:

- *"The purpose of the metric is to guide a decline in the emissions intensity of the real economy assets to which the investor is exposed",*
- *"Short positions do not represent an offset to real economy emissions on the long side and the framework needs to be very clear in avoiding any confusion in the representation of what short exposures achieve"* and
- *"Shorting does not directly reduce current tonnes of CO2 release in the atmosphere, nor does it cause carbon to be sequestered. As a result, shorting is excluded from metrics measuring the current emissions associated with a portfolio"*[11].

However, the paper separately acknowledges that *"shorting individual companies may also create real economy influence (…) through the cost of capital mechanism".*

In the next sections, we show that the exclusion of short positions for the purposes of "Net Zero Materiality" is not logical and consistent with the "Theory of Change" concept. We also highlight that presenting all information individually, gross and net creates a more useful way for pension funds and other allocators to account for their exposure to hedge funds without artificially inflating their alignment metrics.

Shorting and Net Zero

Through the lens of the "Theory of Change" and specifically Tier 3 - market pricing mechanism[12], the effect of short selling is similar to outright selling or divesting of an asset. In addition, short selling can be effectively used in the transition to net zero in many ways such as:

- Allowing a manager to explicitly express a negative view on issuers for carbon related policies. This may send a message to issuers that improvements are required either through short activism or public disclosure of short positions (required in some jurisdictions),
- Causing downward pressure on share prices for issuers that are high carbon emitters which increases cost of capital and could impact executive compensation packages and encourage carbon emission related changes, or
- Helping uncover hidden carbon risks that are inappropriately priced in the market.

Short selling is the extension of the concept of selling or divesting from an asset, which further reinforces market pressure on high emitting issuers through the market pricing mechanism that would otherwise be ignored by responsible allocators who have already divested and therefore exercise no influence.

The justification for the approach *"short selling does not reduce current tonnes of CO2 release in the atmosphere, nor does it cause carbon to be sequestered"* could equally apply to selling an asset. Neither selling, short selling or hedging an asset offsets real economy emissions or reduces the amount of carbon in the

[10] See illustration on page 6 and 19
[11] See Discussion Document, p.19
[12] As set out on page 15 in the discussion paper: Theory of Change: How investors create influence

atmosphere. But they do all exhibit a market pricing (Tier 3) impact,[13] and they transfer the accounting for the carbon emissions to another investor.

Summary of net zero materiality of secondary market activities (Theory of Change):

Secondary market activity	Tier 1 impact (new capital with positive impact)	Tier 2 impact (voting, etc.)	Tier 3 impact (Cost of capital)
Buying	no[14]	Possible (on condition that investors votes/engages in a particular manner)	Reducing cost of capital of issuer
Selling	-	-	Increasing cost of capital of issuer
Short Selling	-	-	Increasing cost of capital of issuer

Controversial assets, including high emitters, will in future likely be held by investors who care less. Shorting allows responsible investors to have influence beyond divesting their own portfolio helping to accelerate the transition to net zero. Therefore, if selling an asset to another investor has relevance for net zero-materiality, we believe that short-selling also should, as it extends an investors' impact beyond shrinking the emission footprint of their own portfolios.

This ties with our findings in our Responsible Investment Working Group that many investors wish to look beyond just a single portfolio. Without including short positions in this metric, at best it results in double counting of carbon emissions across the economy and at worst it provides misleading information to the investor on the portfolio's contribution to the net zero transition.

Conclusion: The net zero materiality framework fails to fully acknowledge the important tool of shorting, which can significantly influence the net zero transition. The exclusion of short positions is not logical and consistent with the "Theory of Change" concept. The approach should consider all factors that create a real economy impact including shorting (delta adjusted). Short positions explicitly help drive emission reduction in the real economy by increasing cost of capital - like selling an asset. The reporting of "Financed Emissions" should therefore include both the long and short carbon emissions in the portfolio. Including short positions highlights that the investor not only drives decline in the real economy emissions of the assets it owns[15], but can also have a positive emissions impact on assets with short exposure.

What about netting for the purposes of presenting "Financed Emissions"?

As a starting point, it is worth noting that all derivatives, long and short, net to zero in risk exposure and "carbon exposure" terms. The proposed approach, therefore, creates an asymmetric framework, which will distort how institutional allocators report alignment metrics (see example further below) and can create situations where allocators with identical holdings will report different emission exposures. This is not ideal for a framework that seeks to accurately account for global emissions and the progress of their reduction.

[13] It is also worthwhile noting that along the same lines, buying a stock does not represent an increase in the amount of carbon emitted, but equally has a real-world impact by in aggregate reducing cost of capital for the issuer (Tier 3).
[14] Only relevant in primary market
[15] See page 7 in Discussion Paper

As we discuss in the partial transparency section below, accounting only for certain parts of the portfolio within the Financed Emissions metric provides the opportunity to window dress the reported numbers for example by holding higher emitters or hedging out the risk of investing in sustainable stocks using the instruments excluded from this metric – i.e., it provides a loophole for greenwashing.

Presenting all information individually, gross and net creates a more useful way for pension funds and other allocators to account for their exposure to hedge funds, without artificially inflating their "alignment metrics" in the context of the "net zero materiality", as shown in the example below:

Case study: Accounting for hedge funds versus internalised management in an institutional allocator portfolio:

Simplified market universe (with total real-world units of emissions: 220,000)

- 1000 shares of corporate A: each share accounts for 120 units of emissions
- 1000 shares of corporate B, each share accounts for 100 units of units of emissions

Economic actors:

- Pension fund 1 combines passive (and cost efficient) index holdings with active management which is delegated to specialist external investment managers such as hedge funds, to improve diversification and add alpha to the overall portfolio. Pension fund 1 also engages in securities lending to increase overall returns. Observation: It would not be unusual that a particular external hedge fund manager takes short positions in stocks, that are held long in the index portfolio, while increasing the exposure to other stocks.
- Pension fund 2 and Pension Fund 3 just hold long positions stocks.
- The positions of Pension Fund 1 mimic the combined positions of Pension Fund 2 + Pension Fund 3

Pension Fund 1 Holdings (units of emission)	Units of Financed Emissions (IIGCC method)	Accounting based on Delta
1000 shares corporate A (500 on loan to Hedge Fund)	120,000	120,000
Hedge Fund: - **Short 500 corporate A** - **Long 500 corporate B**	 0 50,000	 -60,000 +50,000
Total units of financed emissions	**170,000**	**Long: 170,000** **Short: 60,000** **Net: 110,000**

Pension Fund 2 Holdings (units of emission)	Units of Financed Emissions (IIGCC method)	Accounting base on Delta
500 share corporate B	50,000	50,000

Holdings of Pension Fund 3 for both scenarios above:

Pension Fund 3 Holdings (units of emission)	Units of Financed Emissions (IIGCC method)	Accounting based on Delta
500 shared of stock A	60,000	60,000

Result:

- Pension Fund 1's holdings are identical to Pension Fund 2 and 3 combined, but it reports a much higher carbon footprint under the IIGCC method. This means the units of Financed Emissions accounted for in the marketplace is higher than actual emissions.
- The IIGCC method is not agnostic to the implementation of the investments and penalises Pension Fund 1 seeking diversification and alpha by using specialist external managers.
- Institutional investors often have emission reduction targets. As is, the framework discourages the use of specialist external managers and specifically penalises hedge fund managers using the full spectrum of investment techniques, including shorting, which can help accelerate the transition to net zero.
- The example also illustrates that there is no direct link between selling an asset and reducing carbon emissions: markets need to clear, the adjustment mechanism is the price for the asset.

Partial Transparency Concerns

The framework as it stands mandates only partial portfolio transparency for certain metrics - predominantly Financed Emissions. At the SBAI, we believe that full transparency is required to allow investors to make informed investment decisions and would not be supportive of metrics that exclude certain parts of the portfolio.[16] In addition to this point, the proposed exclusion of certain assets in the portfolio provides opportunity for greenwashing as discussed below.

Derivatives
As all derivatives net to zero, logically if the positive impact (Tier 3) of short derivative positions are not eligible to be counted in Financed Emissions, the negative impact (Tier 3) of the associated long derivative positions should also not be counted. This would result in only long physical positions (and their associated carbon) being considered. This would be consistent, but it would not be helpful as it provides the opportunity to trick the system, or greenwash, for example, by holding high carbon emitters via derivatives to lower reported carbon footprints.

Short Positions
Equally, not allowing for short positions to be counted also creates loopholes. It may allow window dressing of average carbon intensity, for example by adding long positions in sustainable stocks and hedging these risks with derivative short positions increasing the portfolio's average ESG score. This would not be possible if both long, short and net positions are provided.[17]

Benchmarks and Targets

We understand the concerns raised about short positions being construed as "carbon offsets" or that hedge funds might claim "climate neutrality" on the grounds of their market neutral position. By advocating for reporting of long, short and net numbers we are not advocating that asset managers or investors take this approach.

[16] Obviously, for asset alignment reporting (see p. 23), "voting" only applies in the context of long cash positions and does not need to be included for long derivatives and short cash and derivative positions.
[17] This example was first mentioned here (https://www.systematica.com/loopholeintheeutaxonomyregulation/#article) in the context of the EU taxonomy regulation)

Rather than breaking the otherwise consistent framework, we believe the working group should clarify the appropriate benchmark a fund is measured against. While it is logical that a long only equity fund can be measured against the carbon emissions of its benchmark (e.g., MSCI World), this is not the case for other strategies, for example a market neutral fund. We believe it would be more appropriate for this type of portfolio to be measured against a benchmark of "0" (baseline) carbon emissions meaning it would only be considered to have a positive climate impact if it demonstrated significantly negative metrics.

As not all portfolios would fit into these two distinct categories (some may have a long bias others might have a short bias) any target or benchmark should be set relative to the net delta of a fund which would account for long and short positions but also for leverage used frequently in hedge funds. We believe this would be a more appropriate way to resolve the concerns noted above.

Conclusion

We note above several reasons why we believe both derivatives and short positions should be included in the calculation of the metrics in this framework:

1. To acknowledge and report on the contribution of short positions to the transition to net zero,
2. To avoid mandating partial transparency that could be misleading at best and greenwashing at worst.

We also note that the use of a different benchmark could more effectively allay concerns about short positions being treated as "carbon offsets".

For these reasons we believe that all metrics should be reported detailing long cash positions, long derivative positions, short cash positions, short derivative positions and net positions. This provides the information an investor will need to monitor the specific objective or commitment they are trying to achieve across their investments and ensure consistency of reporting.

We would be happy to discuss any of this further with you.

Kind regards,

Thomas Deinet

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