June 17, 2022

Submitted via website: https://www.surveymonkey.co.uk/r/LK9CNH8

The Institutional Investors Group on Climate Change
Pennine Place
2a Charing Cross Road
London, WC2H 0HF

Re: Consultation on Incorporating Derivatives and Hedge Funds into the Net Zero Investment Framework

Dear Sir/Madam,

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to represent the views of the global alternative investment industry in this response to the Institutional Investors Group on Climate Change ("**IIGCC**") consultation on Incorporating Derivatives and Hedge Funds into the Net Zero Investment Framework (the "**Consultation**").

We support the IIGCC's efforts to establish a framework for incorporating derivatives and hedge funds into the net zero investment framework. Our members utilize a broad range of investment strategies, and many of them take into account climate risk or have specific products with climate-related objectives. We also agree with the IIGCC's assessment that the use of derivatives and shorting strategies increases the range of opportunities that investors can utilize to exert constructive influence and to achieve their net zero ambitions.

As new regulation continues to emerge related to sustainable finance and climate risk in jurisdictions across the globe, it is increasingly important that regulators, asset managers, and their allocators consider the role of investment tools like short selling and derivatives in ESG investing. It is also necessary to have sensible, evidence-driven, and commonly agreed approaches to measuring the carbon risk exposure and emissions profiles of investment portfolios that include a wide array of asset classes.

In this context, MFA welcomes the consultation's recognition of the need for flexibility to report multiple metrics related to the carbon risk and emissions profiles of investment portfolios in order to promote transparency and provide allocators with the information they need. However, we have significant concerns that the proposed framework does not adequately nor consistently consider the ability for

[1] Managed Funds Association (MFA) represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia.

investment tools which contribute to reallocation of capital to influence the transition towards net zero. We appreciate you taking these concerns into account. Please see our responses to the consultation in the Annex for further details.

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We would be very happy to discuss our response with you or to provide further information. Please do not hesitate to contact the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Jillien Flores

Jillien Flores
Executive Vice President
Head of Global Government Affairs

ANNEX
Response to Consultation Questions

Q1. Do you agree with the approach proposed of integrating derivatives and hedge funds into the Net Zero Investment Framework through portfolio measurement, asset alignment and portfolio management?

◯ Strongly Agree

◯ Agree

◯ Neither Agree nor Disagree

☑ Disagree

◯ Strongly Disagree

If not, please set out your alternative suggestions.

MFA is very supportive of the IIGCC's efforts to integrate derivatives and hedge funds into the net zero investment framework. Our members utilize a broad range of investment strategies, and many of them take into account climate risk or have specific products with climate-related objectives. We also agree with the IIGCC's assessment that use of derivatives and shorting strategies increases the range of opportunities investors have to exert constructive influence to achieve their net zero ambitions. However, we have significant concerns that the proposed framework does not adequately nor consistently consider the ability for investment tools which contribute to reallocation of capital to influence the transition towards net zero.

Q2. Do you agree that the proposed Theory of Change is helpful in establishing a hierarchy of investor influence and that it matches your own broad assessment?

◯ Strongly Agree

◯ Agree

◯ Neither Agree nor Disagree

☑ Disagree

◯ Strongly Disagree

If not, please set out what changes you suggest and why.

MFA welcomes the IIGCC's efforts to recognize the different ways in which investors can impact the real economy and thereby influence the transition to net zero. While many investors utilize tools such as direct engagement with corporates or exercise their voting rights as shareholders, others gain exposure to companies through derivatives or short selling and contribute to the reallocation of capital. To date there has been significant focus on ESG in cash securities on the long side, while the role of investment tools which contribute to the reallocation of capital has not been considered as extensively.

While the proposed Theory of Change is helpful in that it considers more fully the role of indirect exposure and investment tools which can raise or lower the cost of capital for companies, we do not believe that a tiering system is necessary nor an accurate depiction of the impact of different investment tools on the transition towards net zero. In particular, there may be some instances where engagement with an underlying company is not as impactful as an investor gaining significant exposure to a company through derivatives and thereby influencing its cost of capital.

There is a significant body of academic research which shows short selling influences pricing and can impact real economy outcomes.[2] Malloy et al (2007) found that shorting had a statistically significant effect on future returns, implying that ESG related shorts can increase the cost of capital for target companies. Wong and Zhao (2017) show that a variety of financing and investing activities in heavily shorted companies decline by between 7% and 25%, while Boehmer and Wu (2013) find that short sellers have a significant impact on market prices, moving them closer to informational efficiency. Similarly, Saffi and Sigurdsson (2011) have found evidence that restrictions on short selling degraded

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[2] Boehmer, E., C. M. Jones, and X. Zhang (2008): "Which Shorts Are Informed?" The Journal of Finance, 63, 491–527.

Boehmer, E., and J. J. Wu (2013): "Short Selling and the Price Discovery Process," Review of Financial Studies, 26, 287–322.

Cohen, Lauren, Karl B. Diether, and Christopher J. Malloy. "Supply and Demand Shifts in the Shorting Market." Journal of Finance 62, no. 5 (October 2007): 2061–2096.

Dechow, P. (2001): "Short-sellers, fundamental analysis, and stock returns," Journal of Financial Economics, 61, 77–106.

Diether, K. B., K.-H. Lee, and I. M. Werner (2009): "Short-Sale Strategies and Return Predictability," Review of Financial Studies, 22, 575–607.

Engelberg, J. E., A. V. Reed, and M. C. Ringgenberg (2012): "How are shorts informed?" Journal of Financial Economics, 105, 260–278.

Kaplan, S., T. Moskowitz, and B. Sensoy, (2013): "The Effects of Stock Lending on Security Prices: An Experiment," Journal of Finance, 68, 1891–1936.

Malloy, Christopher J. and Diether, Karl B. and Cohen, Lauren (2005): "Supply and Demand Shifts in the Shorting Market," EFA 2005 Moscow Meetings Paper.

Saffi, P. A. C. and K. Sigurdsson (2011): "Price Efficiency and Short Selling," Review of Financial Studies, 24, 821–852.

Wong, Yu Ting Forester and Zhao, Wuyang (2017): "Post-Apocalyptic: The Real Consequences of Activist Short-Selling," Marshall School of Business Working Paper No. 17-25.

price formation, suggesting shorting places a significant role in promoting efficient price discovery and therefore cost of capital for companies.

With this in mind, we believe it would be more useful to introduce categories of activities rather than a tiering system which asserts one type of influence will always be more or less impactful than another no matter the underlying circumstances. We believe that utilizing a categorization of activities would be a more flexible and accurate approach. However, to the extent the IIGCC proceeds with a tiering system, any hierarchy established for the influence of different investment activities should be well supported by empirical evidence.

Q3. For the purpose of portfolio measurement, in assessing the proposal for the definition of financed emissions incorporating derivatives, do you agree that longs should be defined by cash and derivative exposure?

- [ ] Strongly Agree
- [x] Agree
- [ ] Neither Agree nor Disagree
- [ ] Disagree
- [ ] Strongly Disagree

If not, please set out your reasons and any suggested alternative.

Q4. For the purposes of portfolio measurement, in further assessing the proposal for the definition of financed emissions incorporating derivatives, do you agree that shorts should not be included?

- [ ] Strongly Agree
- [ ] Agree
- [ ] Neither Agree nor Disagree
- [ ] Disagree
- [x] Strongly Disagree

If not, please set out the basis on which you propose that their effect on current emissions should be evaluated.

MFA strongly disagrees with the proposed approach to ignore short positions when calculating the financed emissions of a portfolio. Short positions and short derivatives have an impact on portfolios, just as longs do, and ignoring them fundamentally misrepresents both a portfolio's exposure and impact.

If investors must report the long positions they have because those positions influence capital allocation and make it relatively easier for those companies to finance its operations, and by extension its emissions, then we believe the same logic must apply on the short side. Short positions and short derivatives influence capital allocation in the opposite direction and make it relatively harder for a company to finance its operations.

MFA's recently published research paper, *The Use of Short Selling to Achieve ESG Goals*[3], finds evidence that short positions have the potential to reduce capital investment in the most emissions-heavy publicly traded companies by 3-8 percent given the impact of short positions on price discovery. Given the ability for short positions to reallocate capital away from heavily emitting companies, we strongly believe the IIGCC's proposal to ignore all short positions when calculating financed emissions does not adequately consider the impact of changes to cost of capital on the trajectory towards net zero. Similarly, UN PRI's position paper, *Shorting and Responsible Investment*[4], highlights that "short interest in a company can impact its cost of capital, creating an incentive for management to engage with investors on a specific issue or practice to improve the chances of obtaining more favourable financing or a higher valuation. This influence may be direct (as investors borrow or return stock to build or reduce short positions) or indirect (as public short positions can impact investor perceptions of an issuer or asset)." In other words, short positions can lead companies to make changes, including their trajectory towards net zero, to secure better terms of financing. Given the substantial body of evidence that short selling can influence companies by impacting their cost of capital, we strongly believe short positions must be reported alongside long positions in order to promote transparency and ensure investors have a full picture of a portfolio's impact.

An additional concern with the IIGCC's proposed treatment of short positions is that it is inconsistent with the treatment of other investment tools. For example, the IIGCC proposes that indirect exposure through derivatives should count towards financed emissions on the long side but that exposure on the short side should be ignored. As the discussion paper points out, derivative exposure is not the same as cash exposure and does not equate to ownership. Yet, these positions would still be counted towards a portfolio's financed emissions under the proposed framework. Meanwhile, shorts are given a different treatment. We strongly disagree with this inconsistency as it would produce misleading and incomplete metrics for financed emissions.

Moreover, not including shorts disincentivizes managers from holding long positions. Many alternative investment managers operate market-neutral strategies or use short positions to hedge longs. Given this, short positions can actually amplify the potential impact of a manager's long book. As an example, a manager wishing to make a long investment in a company with high emissions in order to engage through standard governance channels to encourage the transition towards net zero may hedge the risk

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[3] Managed Funds Association (2022): "The Use of Short Selling to Achieve ESG Goals." Available at: https://www.managedfunds.org/wp-content/uploads/2022/06/ESG-Short-Selling-White-Paper_Final.pdf

[4] PRI (2021): "Shorting and Responsible Investment: A Review." Available at: https://www.unpri.org/hedge-funds/shorting-and-responsible-investment-a-review/8388.article

of that exposure with an offsetting short position in another high emitter. As a result, the manager is able to influence one emitter through direct engagement via a long position and another through pricing mechanisms via a short position. In this example, the short position not only impacts the cost of capital of the company being shorted, but also amplifies the impact of the portfolio as a whole by allowing the manager to take more longs.

Lastly, not allowing managers to report their short positions alongside their longs, as well as to net shorts from longs in a transparent manner, will lead to double counting of emissions. Consider an example where Investor A borrows a stock from Investor B in order to sell the stock short to Investor C. In this example, both Investor B and Investor C may report the emissions associated with that stock, and unless the short position from Investor A is netted, the emissions will be double counted. This would cause problems in particular for investors looking to aggregate their financed emissions across portfolios or across managers as they would likely be double counting in many instances and therefore producing misleading or inaccurate metrics.

Q5. For the purposes of portfolio alignment, do you agree with the proposed approach for establishing metrics to incorporate derivatives?

- [ ] Strongly Agree
- [x] Agree
- [ ] Neither Agree nor Disagree
- [ ] Disagree
- [ ] Strongly Disagree

If not, please set out your alternative suggestions.

Q6. For the purposes of portfolio alignment, do you agree specifically that shorts may be counted towards an investor's engagement target?

- [x] Strongly Agree
- [ ] Agree
- [ ] Neither Agree nor Disagree
- [ ] Disagree
- [ ] Strongly Disagree

If not, please set out your reasoning.

MFA strongly believes that short positions should be counted towards an investor's target setting. We also note that targets can vary between long-only and long/short managers. While a long-only manager may eventually be able to achieve a net zero portfolio, a long/short manager may be able to set a target beyond net zero. This is similar for traditional benchmarks where a long-only manager might use the S&P 500 as a benchmark, but an equity market-neutral manager may not.

Q7. Do you agree that the proposed de minimis steps for all investors are appropriate for the incorporation of derivatives into a net zero strategy?

◯ Strongly Agree

◯ Agree

◯ Neither Agree nor Disagree

◯ Disagree

◯ Strongly Disagree

If not, please set out what changes you suggest and why.

N/A

Q8. Do you agree that the proposed principles are helpful in integrating derivatives and hedge funds into the Net Zero Investment Framework?

◯ Strongly Agree

◯ Agree

◯ Neither Agree nor Disagree

☑ Disagree

◯ Strongly Disagree

If not, please set out what changes you suggest and why.

While MFA appreciates the IIGCC's efforts to consider how derivatives and hedge funds can be integrated into the net zero investment framework, we worry that the proposed principals may cause hedge funds to be less likely to pursue net zero related objectives given the inconsistent and inadequate consideration of investment tools like short selling.

Q9. In addition to the specific proposals for portfolio measurement, asset alignment and portfolio management, do you agree that making an explicit commitment not to engage in greenwashing in investment activities could help further a net zero ambition?

◯ Strongly Agree

☑ Agree

◯ Neither Agree nor Disagree

◯ Disagree

◯ Strongly Disagree

If not, please set out why along with any alternative proposals.

MFA supports efforts to combat greenwashing. We would also emphasize that risk of greenwashing is present for cash instruments as well as derivatives and that there is nothing inherent about derivatives or short selling that increases the likelihood of greenwashing. We believe initiatives to mitigate greenwashing should apply to all investors regardless of the strategies they employ.

Q10. Do you agree that the proposed approach in this discussion document is applicable to derivatives in asset classes that are not covered?

◯ Strongly Agree

◯ Agree

☑ Neither Agree nor Disagree

◯ Disagree

◯ Strongly Disagree

If not, please set out problem/ special cases that demand alternative treatment.

MFA emphasizes the importance of clearly indicating which types of derivatives the proposed framework would apply to. There are many asset classes outside of equities which have significant implications for net zero accounting including inflation-linked bonds, currencies, commodities, carbon allowances, and carbon offsets. While we encourage consideration of how different asset classes can be incorporated into the net zero investment framework, we caution that applying frameworks meant for equities to other asset classes will not necessarily work in practice and could produce data which is difficult to interpret, or which does not appropriately reflect the underlying exposure or impact of a portfolio.

For example, the impact from an ESG perspective of investing in sovereign bonds is not always clear. The Imperial College Business School, SOAS University of London, and UN Environment published a research paper[5] in 2019 which points out that the climate risk associated with investing in certain developing countries has raised the cost of capital for those countries by 117 basis points. This could actually make it more difficult for those countries to address climate change. With this in mind, it is difficult to assess the impact of an investment in the sovereign debt of a developing country with high climate risk. On the one hand, divesting from that particular sovereign could reduce a portfolio's exposure to emissions, but on the other hand divesting may also slow that country's progress towards net zero. UN PRI's paper, *A Practical Guide to ESG Integration in Sovereign Debt,*[6] notes that given the significant uncertainty as to the timing of physical climate impacts, governments' policy responses and the pace of technological breakthroughs, accurate analysis of the impact of investing in sovereign bonds is challenging.

When considering extending the net zero investment framework to other asset classes, we also encourage the IIGCC to take into account the availability of data and to ensure the proposed framework recognizes the feasibility of collecting reliable and useful data on emissions and climate risk more broadly for asset classes outside of public equities.

[5] Buhr, Bob, Volz, Ulrich, Donovan, Charles, Kling, Gerhard, Lo, Yuen C., Murinde, Victor and Pullin, Natalie (2018): "Climate Change and the Cost of Capital in Developing Countries," London and Geneva: Imperial College London; SOAS University of London; UN Environment.

[6] PRI (2021): "A Practical Guide to ESG Integration in Sovereign Debt." Available at: https://www.unpri.org/fixed-income/a-practical-guide-to-esg-integration-in-sovereign-debt/4781.article