
Systematica Investments Response to the IIGCC Consultation on Incorporating Derivatives and Hedge Funds into the Net Zero Investment Framework

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Executive Summary

Systematica is thankful for the work of the workgroup which conducted a very detailed analysis. We believe that the proposed framework is a step in the right direction and puts forward a few improvements compared to the current state of standards and regulations tackling greenwashing.

However, there are a few problems and inconsistencies in this proposal which are exposed in our detailed responses below. We also make concrete proposals to address those shortcomings and propose a set of alternate rules.

To summarize:

- Just **follow the money and ensure full transparency**. Do not exclude half of the position (shorts) from alignment accounting, simply account for them and raise the bar for those funds.
- **Net Zero is too Easy!** A benchmark climate-unaware Equity market neutral fund is net zero because it has financed short as much emissions as it has financed long. To contribute to climate action, an Equity market neutral fund should have significant negative exposure to emissions or a negative net ITR.
- **The perfect greenwashing device**. In the proposed framework, the exclusion of shorts allows one to greenwash its portfolio by going long a green stock and hedging its risk. This artificially improves portfolio alignment metrics with no money at risk, no net impact to cost of capital and a small cost to investors. Note that this issue is widespread (EU Taxonomy, FCA SDR, SEC proposal, MSCI fund ratings) and we have raised it only recently (May 2022).
- **Measure the right things**. To measure active ownership, voting and engagement, define metrics that capture the actual impact or at least the actual actions (e.g., shareholder resolutions and votes against management). Measuring Tier 1 and 2 potential impact via a measure of cash long positions is not enough and creates the need to separate economic exposure from cash ownership. This in turn incentivizes the focus on only long position which creates the greenwashing loophole above.
- **Net economic exposure is a decent proxy for impact on cost of capital**. The Tier 3 impact concept is clearly defined in the framework and recognizes that shorts can impact the cost of capital as well as divestments. We argue that the net delta is the lens through which that cost of capital impact should be measured, looking through on derivatives and netting the shorts.

Detailed Responses to the IIGCC Survey

5. 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? (Section 2.5)

Agree

6. If not, please set out your alternative suggestions.

N/A

7. 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? (Section 2.5)

Neither agree nor disagree

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

We strongly agree with the idea of laying out a theory of change and broadly agree with the 4 tiers.

We would argue that a simpler tiering would just recognize the three main ways in which investors impact the real economy:

- 1) Provision of financing for companies (e.g., primary market, lending, corp bonds) identified in Tier 1
- 2) Cost of capital identified in Tier 3
- 3) Active ownership and engagement. Currently recognized in Tier 1 (collaborative) and 2 (individual). We would argue more effective metrics should be defined to capture the level of impact of a manager on corporates. These metrics need not be relative to an investor portfolio, one could just count the number of (impactful) votes and the level of participation in and effectiveness of engagement campaigns. The usefulness of shorting in that context can only be assessed once these metrics are properly defined. The threat of shorting much like the threat of divestment can be a powerful lever in engaging with corporates.

There are a few inconsistencies between the examples in the table and the definitions:

Tiers 1 and 2 contain collective engagement actions and stipulate that they require ownership of cash positions. We believe it is possible to participate in collaborative engagement actions without ownership of shares. Shareholder resolutions and proxy voting do require ownership of shares, but these activities fall under Tier 2 in the table.

The table has Activist funds (long and short) listed under Direct Tier 1 degree of Influence. Short activism however does not seem covered by the Tier1 definition above and does not require ownership of shares.

If the action that requires share ownership consists in voting, that activity should be measured directly rather than via a measurement of a cash long position as an investor can have a cash long position without impactful voting.

Note also that many collaborative and individual engagement actions are done with the threat of divestment. We believe that a threat of divestment from a derivative long position or a threat of short selling might be as effective as a threat of divestment. This view seems to be shared with the committee given the inclusion of shorting alongside underweighting and divestment in the cost of capital signalling mechanism in the table for Tier 3.

In Tier 1 and 2, the committee advocates the use of cash long positions hedged with derivatives to facilitate higher Tier 1 and 2 action. We believe that the disqualification of shorts from alignment reporting actually introduces a [loophole](#) through which L/S managers can arbitrarily green their long portfolio without taking any financial risk.

The notion of intentionality is introduced for the first time in the Tier 4 example at the bottom of the table on page 15. This is confusing. In our understanding, it recognises the price impact which is the conduit for cost of capital signalling but rules out the climate influence because of a lack of intentionality. We would introduce it in a section before, but it seems misleading: Is it ok to be long a high carbon emitter or a company without carbon reduction targets if there is no harm meant, no climate harm intentionality? How do you measure intentionality? Can auditors certify intentionality?

9. 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? (Section 3)

Strongly agree

11. 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? (Section 3)

Strongly disagree

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

Ignoring shorts and therefore introducing a non-linearity in the portfolio measurements allows arbitrary [window dressing](#) and improvement of sustainability metrics for the hedge fund industry: Buy a sustainable stock and hedge its risk with a derivative short position. Et voilà, you have a cheap way to improve the financed emissions, SFDR PAI or EU taxonomy disclosure numbers of your portfolio. The P&L risk of that bundle would be negligible but the longs would participate in raising the reported sustainability numbers of the fund.

Note that this issue is not specific to the IIGCC proposal or current draft RTS of the EU taxonomy regulation. MSCI does look through some derivatives such as single stock futures and options. However, much like the coming regulation, they seem to consider shorts as zero in the numerator of computations that determine a fund ESG quality score. It is theoretically possible to improve a MSCI ESG fund rating from BB to A by using this trick.

Furthermore, we disagree that the target for carbon net financial risk exposure should be set at or below the long-only baseline index. For Equity Market Neutral or L/S funds, the target should rather be relative to zero or a net delta reweighted metric of the long-only baseline.

For instance, a random Equity Market Neutral fund would be long a random portfolio on the long side and another random portfolio on the short side. In expectation those two portfolios would be in line with the broad market and the net (long minus short) metric of carbon net financial risk, net financed carbon or net portfolio alignment would be zero.

To contribute to sustainability or a net zero future, the active market neutral fund would need to demonstrate significant negative metrics, much like a long only portfolio would need to demonstrate metrics significantly below the long-only baseline.

Similarly, and consistent with arguments on page 25, a levered fund providing 2x exposure to the market should not be constrained to meet the same absolute metrics as a long-only 1x active peer.

This is why, consistent with the delta-based treatment of derivatives in this IIGCC discussion paper, the target should be relative to the net delta of a fund.

13. For the purposes of portfolio alignment, do you agree with the proposed approach for establishing metrics to incorporate derivatives? (Section 4)

Disagree

14. If not, please set out your alternative suggestions.

Metrics table page 26:

In general:

We would add a few metrics, in general metrics used on the long side should also be reported on the short side (except where they refer to voting which is not available on shorts or derivatives). These metrics should be expressed in units that make it possible to compare the longs to a benchmark, accounting for the leverage of the book and netting the longs with the shorts. The net result should then be compared with a net delta adjusted long-only benchmark, which would typically be 0 for EMN.

In particular:

In C. Voting: In support of the argument that "low current financed emissions [do not] equate with high future influence", we would measure the carbon intensity or carbon footprint of holdings for which votes were aligned with climate (for a climate-related proposal or against management if appropriate)

In F. Alignment for shorts: we would use the same metrics as in A. Alignment. We would report on long / short / net. For an EMN fund, we would target significant negative net (long minus short) numbers for the positive metrics in A.

The metric "% short exposure with climate related thesis" is difficult to evidence / audit. Usually short positions are the results of many factors playing against a company.

H: Historic emissions progress made by companies engaged. These are metrics on longs, we would add the same on shorts.

Asset alignment targets box page 27:

Strategy / asset class level coverage objective: we do not think that we would need a specific objective on the short side, but if the shorts are less aligned than the longs this is a plus. L/S managers should be ranked on that net metric. Note that ideally all companies become aligned and therefore it is not reasonable to ask for a portfolio to have a significant net positive alignment coverage metric. Similarly, when the market coverage approaches 100%, the net coverage converges to the net delta.

The paragraph starting with "Whereas" is duplicated.

15. For the purposes of portfolio alignment, do you agree specifically that shorts may be counted towards an investor's engagement target? (Section 4)

Agree,

16. If not, please set out your reasoning.

Comments pertaining to the different metrics on page 26:

B1: % engaged by Climate Action 100+: this should be reported for longs, shorts and net. At the limit this is bound to be zero when either all companies are engaged by Climate 100+ or no companies are engaged anymore.

B2: % engaged directly by manager on climate issues with clear milestones set. This should be reported for longs and shorts, the absolute sum of longs + shorts reflects the intensity of engagement in the portfolio, the net sum long – short indicates a sort of P&L sensitivity to the success of these engagements.

B3: Number of engagements with companies on climate related topics over the last quarter this should be reported for longs and shorts separately and together (like B2)

17. Do you agree that the proposed de minimis steps for all investors are appropriate for the incorporation of derivatives into a net zero strategy? (Section 7)

Appropriate

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

N/A

19. Do you agree that the proposed principles are helpful in integrating derivatives and hedge funds into the Net Zero Investment Framework? (Section 7)

Agree

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

We have some reservations on principle 5 if it is the basis of some of the technical points we argue against in the rest of this document. We believe that a more appropriate Principle is one of "follow the money and full disclosure": no part of the portfolio should be immune to reporting on a given metric. The only way to improve alignment without financial risk should be active ownership: engagement and voting. Investors should report on these activities regardless of the positions in the portfolio.

When the portfolio holdings are measured (e.g., % with credible science-based plan for net zero), an investor should not be able to improve alignment metrics without altering the financial risk of the portfolio (greenwashing). We show in a [separate note](#) and in a previous section that this greenwashing trick is possible when the alignment metrics are computed only from longs and not netted.

21. 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? (Section 7)

Agree

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

We strongly agree on the fact that greenwashing should be banned and prosecuted. This is why we engage with regulators and standard setters to [close greenwashing loopholes](#).

But for a such a system to work, the rules need to be clear and unambiguous. Some greenwashing examples in section 6 are not clear-cut.

Examples on page 30:

Example 3: this is clearly window dressing / greenwashing. But why limit it to non-IIGCC investors? An IIGCC membership does not prevent greenwashing activities.

Example 4: what makes this greenwashing? The broad nature of the index versus a handpicked set of high emission companies? Or is it the EM vs DM nature of the index? What if a manager was going long DM country indices with highest renewable energy generation versus short DM country indices with coal and oil-based energy generation?

Table on page 31

- 1) Long high emitters via derivatives. The framework looks through on derivatives. This scores badly on all metrics. How could this be considered green (and greenwashed)? The only metrics that would measure 0 are the ones that limit their scope to long cash positions, which is a methodological error as argued above.
- 2) Long tech and pharma, short index. This seems borderline. The formatting of that example seems biased:
 - a. Why is new capital supply set to No? "Possibly" like on page 30, would have been more conservative as tech companies could have >5% revenue in climate mitigation activities.
 - b. Potential tier 1 and 2. On page 30 No/None is reserved for derivatives. "Low" would seem more adequate. Arguably the score should be lower than "Positive" as this is given to Long low emitter climate solutions (cash)/ Short high emitter on page 30.
 - c. Tier3 cost of capital: the None should have been coloured white, not red, to be consistent with page 30

On the other hand, Example 2 clearly flags that shorts should be netted with longs for reporting of carbon allowances. This is consistent with our argument: to simplify the framework we should net all shorts against the longs and set targets accordingly. How a long position in carbon allowances (and especially carbon futures) should be treated in terms of carbon accounting is outside of the scope of this question.