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Commodity Futures Trading Commission
Three Lafayette Centre
1151 21st St. NW
Washington, DC 20581

September 11, 2022

Dear Sir\Madam:

This letter is a response to the Request for Information on Climate Related Financial Risk that the Commodity Futures Trading Commission (CFTC) published at 87 Fed. Reg. 34856 on June 8, 2022 ("RFI"). I am a professor of business law at Seton Hall Law School, and, among other things, previously practiced derivatives law in regulatory and transactional capacities at Sullivan & Cromwell LLP and Sidley Austin LLP. My scholarship focuses on derivatives and other financial markets, and I have a deep appreciation for the challenges the CFTC and other financial regulators confront as (a) our understanding of the risks and opportunities that financial

institutions and markets face is refined and expanded, and (b) the role of financial regulators evolves to considering issues far beyond their historic expertise. I write in my personal capacity, and the views expressed in this letter represent only my personal views. The views expressed in this letter are not the views of Seton Hall University, Seton Hall Law School, or anyone else associated with Seton Hall.

The focus of this letter is on contractual innovation observed in over-the-counter swap markets, and specifically, provisions adjusting payment flows based on conditions related to carbon emissions and other socially relevant operational outcomes.[1] ISDA has written a number of reports on this emerging phenomenon, which I will refer to as "ESG-linked swaps".[2] I have written an extensive research piece on this subject, which I would be glad to share with you and the CFTC – but remains private pending its publication. Thus this letter is a selective summary of issues I see the ESG-linked swaps pose to derivatives markets and their regulation. The issues identified are relevant to regulators beyond the CFTC, and I applaud the CFTC's work – whether through the Financial Stability Oversight Council or otherwise – to share information, harmonize approaches, and otherwise develop a well informed and consistent framework for addressing climate related financial risk.

ESG-linked swaps pose numerous issues for the CFTC and other financial regulators, particularly those with jurisdiction over swap dealers. ESG-linked swaps provide benefits to the swap dealers supplying them, including:

1. The new contractual provisions include metrics and other proxies for clients' performance on dimensions that go beyond the traditional scope of financial and operational disclosure dealers receive from their clients (whether directly, through affiliates or through information intermediaries). Many of the early ESG-linked swaps—as more fully covered in the ISDA reports referenced above[3]—alter cash flows on the basis of the client's (and occasionally the dealer's) climate-change relevant activities. This provides dealers with a fuller view of their clients' activities, which may improve calculations of default and other risks related to pricing and credit risk management.
2. The new contractual provisions may allow dealers to reward clients that pursue business policies that reduce reputational, regulatory or other risks to the client and thus benefit the dealer through more long-lasting, repeat, relationships.
3. The new contractual provisions serve branding purposes, allowing dealers to attract clients, employees and otherwise appeal to stakeholders. The flip-side of this benefit is that the provisions may contribute to greenwashing as dealers (or their clients) exaggerate their commitments to social responsibility.

[1] In other words, most of my comments relate to "Product Innovation" and questions 18, 19 and 20 of the request for information.
[2] The popular term "ESG" refers to the use of environmental, social, and governance factors in business decisionmaking. See ISDA, *Sustainability-linked Derivatives: Where to Begin?* (2022); ISDA, *Regulatory Considerations for Sustainability-linked Derivatives* (2021); ISDA, *Overview of ESG-Related Derivatives Products and Transactions* (2021).
[3] See footnote 2.

Dealers' experimentation with provisions adjusting cash-flows on the basis of clients' ESG performance also provides social benefits. These provisions lead to private investment in measuring and verifying performance on socially relevant dimensions (e.g., climate change and other environmental impacts). Just as financial accounting began as a purely private set of principles and practices to assist with business management and subsequently was incorporated into myriad regulatory regimes, ESG metrics are an early form of social accounting that may enable further private and public regulation. The CFTC and other financial regulators face a difficult question whether to promote these socially beneficial investments in measurement of social outcomes, which are at least facially beyond the jurisdiction of federal financial regulators.

ESG-linked swaps also pose risks and challenges, including:

1. As is the case for single name credit default swaps within the SEC's purview, there is a lack of balance across the market between natural short and natural long positions on ESG-linked payment flows. For example, when a dealer enters into a swap that provides a client energy utility with a discount on its periodic payment if the utility achieves a specified improvement in its renewable energy generation capacity (e.g., by installing additional wind turbines), who in the market would take the opposite position so the dealer can directly or indirectly offload related risk? Although this letter is focused on ESG-linked swaps, similar challenges involving imbalances between natural longs and natural shorts are likely to be present for other climate-change relevant products. Furthermore, ESG-linked payment provisions in swaps continue to be idiosyncratic and largely un-hedgeable. This leads to swap dealers warehousing related risk.
2. Relatedly, ESG-linked swaps may be more difficult to terminate or reduce through offsetting transactions and may be substantially less liquid than their plain-vanilla counterparts.
3. As referenced above, firms may alter plain-vanilla swaps to include ESG-linked payment flows in order to posture as socially responsible and appeal to constituencies that are not substantively being served.
4. For clients, ESG-linked payment flows are the opposite of hedges. These provisions generally force the client to pay exactly when the client fails to achieve a target relevant to emission reduction or other socially relevant performance. In this scenario the client is both paying more under the swap and, presumably, in a weaker position due to coming short in achieving its performance target.
5. ESG-linked swaps may be difficult for back-office, middle-office and similar operations as they create unique challenges in calculating payment obligations, tracking swap terms within established data structures, calculating related risk (including prudent collateral requirements), and resolving potential disputes.

ESG-linked swaps also pose unique regulatory challenges, including:

1. Supervision should be aware that there are questions over certain ESG-linked provisions enforceability, as well as the risk-relevant considerations raised above.
2. For the reasons described above, ESG-linked provisions are unlikely to create payment flows that hedge the client. Should these provisions disqualify the overall swap—even

where ESG related cash flows are de minimis—from the exemptions from clearing, platform execution, margining and other rules available to hedge transactions?

3. Current reporting specifications may not accommodate the idiosyncratic adjustments to payment flows that occur when ESG targets are (or are not) met.

Related to the regulatory challenges discussed above, it is notable that ESG-linked swaps originated in Europe and continue to be predominantly available in Europe and Asia. Are the specific regulatory concerns that limit adoption of ESG-linked swaps within the U.S.? And if so, are these limitations desirable?

As discussed above and developed in significantly greater detail in my research, ESG-linked swaps pose novel concerns and opportunities. I hope that the CFTC alongside other financial regulators considers how these novel contracts impact policy goals and supervision. These deliberations are complex, and may require iteration and refinement in policy stance – Rome was not built in a day. I would be honored to discuss these topics further with you, your colleagues and any other interested parties and I would be glad to assist in any relevant analysis and considerations. I believe that tackling climate change as well as other social issues through partnership between governmental bodies, market participants, academics and other members of the not-for-profit community is our best chance for positive policy change. Again, I sincerely applaud your work and I would be glad to hear from you at ilya.beylin@shu.edu to discuss these and related matters further whether via setting up a call or through correspondence.

Sincerely,

Professor Ilya Beylin

CC:

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