LOOPHOLE IN THE EU TAXONOMY REGULATION

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Asset managers around the world are seizing the responsible investment opportunity by launching a plethora of "sustainable" or "ESG" labelled funds. Meanwhile policy makers and regulators rushed to protect the end investor against greenwashing by introducing disclosures of sustainability metrics computed from portfolio holdings (e.g. in the Sustainable Finance Disclosure Regulation — SFDR) and defining what activities are sustainable (EU taxonomy regulation). The SEC is moving in this direction too with a proposed rule on climate disclosures.

There is however a gaping loophole. The current wording of the EU taxonomy excludes derivatives and shorts from the computation of sustainability metrics. This 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 SFDR 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 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.

The debate around disclosure and netting of shorts is raging and there are many other good reasons to account for shorts as a negative number. The arguments against tend to revolve around interpretability issues or around rebutting extravagant claims of fungibility with carbon offsets, or of impact on costs of capital. According to the current text of the Taxonomy, the motivation to exclude derivatives is to reduce the complexity and cost of reporting. I believe this complexity is worth it if it enables better transparency and closes this reporting loophole.

In practice, exchanges and index providers could reduce the complexity by providing the appropriate aggregate disclosure numbers: if an index provider can compute a price series, it can also provide a weighted average disclosure number. In addition, we should weigh derivative positions by their delta (net market exposure), especially if negative.