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MARKET STRUCTURE

THE ROLE OF CAPITAL MARKETS IN THE GREEN TRANSITION

Optiver supports open discussion and debate on all market structure and regulatory topics that would lead to an improvement of the market.

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Optiver believes that the industry and policymakers play an important role in the green transition. Various concrete actions like the launch of ESG (environmental, social and governance) products and the implementation of the EU taxonomy are already taking place. As a next step, Optiver believes that the following initiatives would be most effective in speeding up the green transition. The industry needs to build a liquid ESG product scope by creating products that meet investor demand and are successfully marketed. At the same time, we have to ensure that ESG products are meaningful. Optiver sees standardising ESG (non-financial) information published by companies and making ratings among different sustainable rating agencies comparable by creating a more common way of assessing companies as logical first steps.

Under the Paris Agreement on climate change, the European Union (EU) has committed to limit global warming to below 2°C by cutting greenhouse gases by 40% by 2030. According the European Commission, such an ambition will require EUR260 billion funding per annum. As indicated in the organisation's 'Financing Sustainable Growth' action plan, capital markets play an instrumental role in addressing this gap by reorienting capital to sustainable investments, managing financial risks coming from climate change and fostering transparency and long termism.

Optiver Europe wants to contribute to the discussion around the function of capital markets in the green transition by reflecting on the role of market infrastructure providers (e.g. exchanges, liquidity providers, general clearing members) and policy makers, and what the next steps should be.

THE ROLE OF MARKET INFRASTRUCTURE PROVIDERS IN THE SHIFT TOWARDS SUSTAINABLE/ESG INVESTMENTS

There are various ways in which market infrastructure providers can assist in the green transition:

LIQUIDITY PROVIDERS

Liquidity providers can enable the shift towards sustainable investments by providing liquidity in ESG products, making them attractive/cheaper to invest in for the end investor. This is done by providing a tight bid-ask spread and showing volume that contributes to a deep liquid market.

As a global market maker, we are committed to fulfilling our role in the green transition. For Optiver Europe, environmental, social and governance considerations are integrated in our operations and decision making; it's a way of doing business. We take a holistic approach to this, considering both our operations and our core business.

From a company point of view, we do not only try to limit our environmental impact through recycling initiatives, but at Optiver Europe, we also offset our carbon footprint by 200% through reforestation projects globally.

Next, and more importantly, we aim to fulfil our role in the green transition through our core business; providing liquidity. At present, Optiver Europe provides liquidity in >100 ESG instruments.

By providing liquidity in ESG products with a tight bid-ask spread and volume, Optiver Europe can play a vital role in the green transition. This helps minimise the cost for investing in ESG products, which in turn helps investors reorient their capital to sustainable investments. At the same time, and as outlined in a paper published by CEPS and ECMI[1], providing liquidity in derivatives markets enables investors to manage risk by hedging their positions, which is crucial for long term investments and contributes to long termism. In addition, by providing a tight bid-ask spread, climate change related financial risks can be hedged with minimal cost (contributing to enabling and mainstreaming the management of financial risks coming from climate change).

At Optiver Europe we have defined an ESG market making strategy that is based on 2 principles:

ABILITY TO ADD VALUE TO THE MARKET

For Optiver Europe to be able to successfully provide liquidity we need to be able to add value to the market. This means being capable of pricing competitively by showing a tight bid-ask spread and volume. Next, it might also appear that practical limitations like tax reasons (e.g. a financial transaction tax) hamper us to add value to the market.

PRESENCE OF INVESTOR DEMAND AND COMMITMENT FROM MARKET INFRASTRUCTURE PROVIDERS

In addition to commitment from liquidity providers like Optiver, it is important for other market infrastructure providers to have a good understanding of what kind of ESG products the end investor wants to trade. Consequently, these products need to be created and marketed accordingly.

[1] Derivatives in Sustainable Finance, Lannoo and Thomadakis, CEPS and ECMI, 2020

EXCHANGES AND ISSUERS[2]

Exchanges play a vital role in developing a successful ESG product scope that enables end investors to shift to sustainable products:

- Match supply and demand: this means developing ESG products that the end investor wants to trade and invest in. Like any other product, enabling this means having an open dialogue with the end investor on what kind of products should be launched. At Optiver Europe we have noticed that exchanges have a strong commitment towards ESG. Unfortunately, the development of meaningful ESG products remains a complex task. We would like to point out two hurdles:

  Firstly, when developing ESG products, exchanges often work together with Sustainable Rating Agencies (SRAs). ESG products can vary greatly in the way ESG is incorporated. For example, the STOXX Europe 600 ESG-X index and the S&P 500 ESG index both carry the name ESG, but one is much stricter than the other in terms of exclusion criteria. Both indices exclude companies that are non-compliant with the UN Global Compact Principles, but S&P 500 ESG also excludes 25% of the lowest performing firms (which is based on the ESG rating of the respective SRA):

INDEX	# AND % OF EXCLUSIONS
STOXX Europe 600 ESG-X (cooperates with Sustainalytics)	• Approximately **20 exclusions**, -4% (compared to the STOXX Europe 600 Index)
S&P 500 ESG (cooperates with SAM)	• Approximately **150 exclusions**, -30% of the worst performing firms (compared to the S&P 500 Index)

  Secondly, we observe a large number of ESG products being launched, sometimes without a clear demand. Lack of clear demand makes the market more complex and fragmented. This, in combination with different ways of integrating ESG principles into ESG products (e.g. ESG scores from different agencies and varying selection criteria, see below for more detail) makes it difficult for the end investor to determine what to trade. This could ultimately result in end investors staying away from investing in ESG products.

  Optiver Europe encourages issuers and exchanges to create more harmonisation between ESG products and make differences between ESG products clear to the end investor, so informed decisions can be made about how to incorporate ESG in their investments.

[2] Issuers: the issuer responsible for the creation of a product, this could be for example an ETF issuer or an exchange

- Make it attractive to trade: once a product is launched, it needs to be appealing for the end investor. This can be done by developing competitive fee schedules (exchanges) and attractive creation/redemption levels and expense ratios (issuers).
- Incentivising deep liquid order books through attractive market making programs: like ESMA notes in their response to the Sustainable Finance Strategy Consultation from the European Commission[3], attractive market making schemes for liquidity providers will help in pricing ESG products competitively. This will in turn also be reflected in the transaction cost for end investors.
- Marketing: for the end investor to start trading an ESG product, they should be made aware of its existence. Targeted marketing will be essential for creating a liquid ESG instrument.

For Optiver Europe to provide liquidity in an ESG product, we need to be able to add value to the market and, as described above, there needs to be external commitment.

GENERAL CLEARING MEMBERS (GCMS)

For GCMs there is also a role as they could include ESG elements (e.g. diversity, sustainability) in client onboarding and performing client portfolio assessments. The latter does not only give GCMs more clarity into what extent their clients' portfolio is ESG, but also gives more insight in the ESG risks (e.g. climate change risk) GCMs indirectly face through their clients. Depending on the type of assessment, ESG ratings, an ESG framework (e.g. TCFD, GRI) or the European taxonomy can be used for this. To further push the shift towards sustainable investments, clearing and settlement of ESG products (temporarily) can be made cheaper. For the liquidity provider, this would benefit the assessment of whether or not to start providing liquidity in an ESG instrument. Alternatively, a GCM could also offer better pricing when their client scores positively on their ESG assessment.

EU TAXONOMY

The new EU framework, agreed in 2019, aims to give more clarity on the extent to which an investment is considered sustainable. It is based on 6 EU environmental objectives. At this point it is only focused on environmental aspects. To create a full picture, Optiver encourages to also include social and governance aspects into account.

POLICY MAKERS TO HELP IMPROVE TRANSPARENCY AND HARMONISATION IN ESG DATA/RATINGS

As mentioned earlier in the paper, the development of a successful ESG product scope remains a complex task. Optiver Europe sees opportunity for policy makers to jump in and improve transparency that would benefit the development of a meaningful ESG product scope.

The construction of ESG products largely depends on ESG data and ratings provided by sustainable rating agencies (SRAs - these ratings determine whether certain constituents are included in an index). With a large number of ESG products being launched, it means that the dependency on ESG data and ratings is increasing. When taking a closer look at this, two main problems lead to incomparable ESG ratings

[3] Response to public consultation EC consultation on a Renewed Sustainable Finance Strategy', ESMA, 2020

making them incomprehensive and less meaningful. Policy makers have a role to play to improve this.

1. Due to the lack of standardised non-financial information (NFI), SRAs are forced to base their ratings on information that is not comparable. One source that SRAs use is non-financial information that companies have to report on. However, the non-financial information metrics published are different for every firm. Due to lack of clear guidance or regulation, companies may use international or national guidelines like the United Nations Global Compact, ISOO 26000, etc. This leads to reporting differently on metrics that the sustainable rating agency (SRA) assessment relies on. This makes it difficult to compare assessments within the same SRA, making them less meaningful.
2. The method of assessing a company on ESG is different for every SRA and is proprietary. As there is no legally binding definition of ESG, SRAs take different metrics into account when rating companies on their ESG performance. Some might, for example, take child labour into account while others don't. To give a better indication, MIT recently completed a study on the 5 largest ESG rating agencies[4]. It indicated a correlation of only 0.61 between ESG ratings (to compare, the credit ratings of Moody's and S&P have a correlation of 0.99). The differences between ratings are mainly explained by differences in measurement, making it difficult to come up with truly meaningful and harmonised ESG ratings.

These problems make it difficult for an exchange to develop meaningful ESG products and harder for the end investor to understand to what extend their investments are ESG or not. To improve this, Optiver Europe encourages policy makers to look into standardising non-financial information provided by companies (e.g. through the creation of a uniform framework) and, like credit rating agencies, regulate SRAs. A start could be developing a uniform non-financial information framework that companies have to report on and creating a list of metrics that should be assessed for an ESG rating.

LOOKING AHEAD

Various concrete actions like the launch of ESG products and the implementation of the taxonomy are already taking place. As a next step, Optiver Europe believes that the following initiatives would be most helpful to speed up the green transition:

- BUILDING A LIQUID ESG PRODUCT SCOPE by creating ESG products that meet demand and are successfully marketed. In addition, it is essential to make it attractive for the end investor to trade by minimising transaction

[4] Aggregate Confusion: the divergence of ESG ratings, Berg, Koelbel and Rigobon, MIT Sloan, Massachussets Institute of Technology, 2020

costs through favourable fee schedules, attractive creation/redemption levels and competitive market making schemes.

- DEVELOPING MEANINGFUL ESG PRODUCTS;
  - Make ratings issued by SRAs more comparable by standardising ESG information in non-financial information (NFI) reported by companies. Creating a standardised reporting framework enables SRA's to assess ESG efforts of a company in a homogeneous way and avoids the problem of assessing companies on varying available information.
  - Make ratings among different sustainable rating agencies (SRAs) comparable by creating a common way of assessing companies by regulating SRAs. This would entail creating a common set of metrics for SRAs to consider when rating a firm on their ESG efforts. A first step could be defining a list of metrics that should be considered when assessing a firm on ESG factors.

Optiver Europe looks forward to playing its role alongside policy makers and the rest of the industry in carrying out the green transition.

ABOUT OPTIVER