Views on proposed EU ESG Ratings Regulation

September 2023

Introduction

AFME welcomes the European Commission's proposal for a regulation on the transparency and integrity of ESG ratings. As has been acknowledged by IOSCO, the EU authorities and in other jurisdictions, ESG ratings play an increasingly important role in financial markets. It is an important initiative to enhance trust and the reliability of ESG ratings and AFME supports the Commission's efforts to ensure that ESG rating activities are conducted in accordance with the principles of integrity, transparency, responsibility and good governance, in accordance with the IOSCO Recommendations on ESG Ratings and Data Product Providers (the "IOSCO Recommendations"). As the Commission has recognised, it is also important not to unnecessarily stifle further innovation and development of the market.

Our views provide the perspective of our bank and asset manager members from a user, rated entity and regulated financial undertaking perspective.

AFME supports the proposal to introduce a regulatory regime for (currently unregulated) ESG ratings providers with the objective of enhancing the transparency and integrity of ESG ratings products. We support this being aligned with the IOSCO Recommendations including through the introduction of transparency and governance requirements.

In summary, our key recommendations are to:

- clarify the scope to ensure that it does not unintentionally capture products or activities of regulated financial undertakings, as they are already subject to authorisation and regulatory requirements under existing regulation;
- introduce transparency and governance requirements for ESG ratings providers aligned with the IOSCO Recommendations;
- support efficient and effective interactions between ESG Ratings Providers and rated entities; and
- ensure that the third country regime is workable in practice and that requirements are interoperable with similar requirements in third countries.

Scope: activities of regulated financial undertakings

It is essential to review the proposed scope of the regulation to ensure that it does not unintentionally capture certain products or the activities of regulated financial undertakings such as banks, investment firms, asset managers, insurers and benchmark administrators. We understand that the policy objective of the proposed regulation is to address the gap in the regulatory perimeter for specialised providers of ESG ratings only, rather than introduce new licensing requirements for existing regulated financial undertakings and the products and services they currently offer. This is supported by the following:

1) the summary in the European Commission's impact assessment states that "this initiative will target the specialised entities providing ESG ratings to the public or to subscribers";
2) Article 15 of the proposal sets out that ESG rating providers must not also provide certain other activities (including investment and/or banking activities), which – coupled with the above point –

indicates that this proposed separation of business and activities is targeted at restricting specialised entities from providing banking and/or investment activities alongside ESG ratings activities rather than the reverse; and

3) ESMA's call for evidence on the market characteristics for ESG rating providers in the EU which describes banks and investment firms as users of ESG ratings, rather than as providers.

In support of the above policy intention, we note that the regulation proposes to exclude "ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in-house financial services and products" and "products or services that incorporate an element of an ESG rating". However, the current draft proposal presents an inherent risk of the activities of regulated financial undertakings being brought within scope, contrary to the stated policy intention of this initiative.

Accordingly, we ask that an express exemption for existing regulated financial undertakings is included in the regulation. We propose that this exemption makes clear that both EU and third country regulated financial undertakings can benefit from the exemption to ensure a level playing field.

Alternatively, clarifying the existing proposed exemptions would help improve the legal certainty in this regard.

Absent such an amendment to the proposed text, there is a material risk the regulation will unintentionally capture products or services that may be provided by regulated financial undertakings. For example:

- investment research and other research reports which include analysis of ESG factors and which are produced by analysts within a MiFID II compliant control framework or third country equivalents;
- financial benchmarks (as defined under Article 3(3) of EU Benchmark Regulation) or third country equivalents;
- mandatory regulatory disclosures such as percentages of investments assessed as 'sustainable investments' under the Sustainable Finance Disclosure Regulation;
- ESG ratings or scores that are disclosed by regulated financial undertakings as part of the delivery of a product or service. This might include disclosure of the results of a specialist provider defined metric or calculation, which does not entail any additional analysis of ESG characteristics by the regulated financial undertaking.

It is imperative that the proposed regulation is amended as described below in order to avoid duplicative authorisation and regulatory requirements and potential conflicts between regulation by National Competent Authorities under other financial services regulation, and ESMA under the ESG ratings regulation.

It is also important to expand the proposed exclusion of ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in-house financial services and products to cover ESG ratings that may be used within a corporate group.

Finally, we support the proposed exemptions for products or services that incorporate an element of an ESG rating and ESG ratings from an authorised ESG rating provider that are made available to users by a third party. It would be helpful if the co-legislators could explicitly clarify that the activity of "providing" ESG ratings relates to the production of such ratings and does not capture the distribution or placement of a third party produced ESG ratings by a financial services intermediary (for example where embedded within a bond or

other financial instrument). Defining the scope in Article 2(1) as applying to "ESG ratings issued by producers of ESG ratings" would further clarify this.

Scope: raw ESG data products

We note the proposal to exclude raw ESG data products from the scope of the regulation. The importance of the market for ESG data products alongside ESG ratings is acknowledged in the IOSCO Recommendations (which cover both ratings and data products) and by ESMA[1] alongside other supervisory authorities.

It is critical to ensure trust in the reliability of providers of both ESG ratings and ESG data products, including raw ESG data products. While many ESG data products are likely to fall within the scope of either the definition of "score" or reporting and disclosure requirements under existing regulations, the boundary between 'score' and estimated/proxy data or any "processed data" (e.g., temperatures; transition scores) is unclear and complicated; the same goes for controversies alerts which are often subject to a ranking by an analyst who assesses the severity of the controversy.

AFME members wish to reiterate the importance of the reliability of raw ESG data products as raw ESG data products are increasingly relied upon by investors and financial institutions for purposes including investment decisions, risk management and their own disclosures.[2] . Financial institutions continue to rely on ESG data products and even as the data gap should diminish with the implementation of the CSRD, this will take time and estimates will remain important for companies outside the scope of the CSRD. AFME members report from their experience that some ESG data product providers lack robust internal controls over data, including over raw data, and users face too many errors, including discrepancies between the raw metrics reported by the data provider and those disclosed by the reporting entity. However, the contractual relationship with providers proves to be insufficient to remediate deficiencies in data reliability. Changing data providers is a very big challenge for users and, for data coverage reasons, can prove quite difficult given the structure of the market (concentrated on large players, or niche players for specific coverage).

As such, AFME members emphasise the importance of examining the market for raw ESG data products and the effect that this has on the integrity and effective functioning of markets. We recognise that efforts to enhance the availability and comparability of corporate sustainability reporting in the EU and other jurisdictions should help address some challenges in the ESG data products market. However, raw ESG data products include data that is not disclosed under a regulatory framework and where it may be important to ensure transparency over the data sources, time stamps, use of estimates, etc, and that providers of such products have appropriate processes and controls in place.

It is therefore critical that appropriate steps are taken to reduce the risk of unintended greenwashing by both ESG ratings and ESG data providers, and we consider that it is important for the European Commission and ESMA to continue to assess the market for ESG data products and to keep the need for taking regulatory action under review. While we acknowledge that the proposed regulation would need to be tailored for providers of raw ESG data products because the nature and associated risk with such products differs in some respects from ESG ratings, the importance of the role of ESG data products in addressing greenwashing risk is such that we recommend that a mandate is provided in the regulation for ESMA and the European Commission to provide recommendations and take steps to enhance trust in raw ESG data products, in line with the IOSCO Recommendations.

[1] See ESAs Progress Report on Greenwashing, May 2023, para. 124

[2] For example, the Financial Times reported that "Investors appear to be using more bottom-up data to shed light on specific investment issues, with the use of ESG ratings as a primary tool plummeting", 7 August 2023

Scope: ESG controversies

AFME considers that the collection and assessment of ESG controversies should be considered by the co-legislators, and notes that controversies alerts are classified as data by IOSCO and, as such, are covered by its recommendations**.** Whilst we understand there has been no proposal to exclude controversy reports, screenings or norm-based research from the regulatory intervention being consulted on, we believe their explicit inclusion would benefit users and providers of ESG ratings.

Controversy reports and alerts, also known as norm-based research, are typically produced by ESG ratings and data product providers for two purposes: i) as standalone controversy report or alert which may be used by investors as additional screening mechanism, or by proxy advisors when producing recommendation reports; and ii) as a data point considered as part of an ESG rating or scoring process. Like with ESG Ratings, methodological approaches underlying controversy reports and alerts are very diverse, which, when combined with issues regarding the availability, quality and comparability, can result in low correlation and high divergence between providers even where products are aiming to address the same objective. To develop trust and promote confidence in the ESG ratings space, both purposes should fall within the regulatory perimeter. We would note that controversies are often assigned their own rating (e.g., severe / moderate) based on the rating agencies' own methodology i.e., rating providers are not just providing data, they are actively providing a judgement on the data before distributing it to the market.

General principles and transparency

AFME supports the proposed general principles in Article 14. We encourage the co-legislators to maximise alignment with the IOSCO Recommendations to promote interoperability with similar requirements which are being introduced in other jurisdictions such as the United Kingdom, Japan, Singapore and others.

AFME supports the proposed transparency requirements set out in articles 21 and 22. Transparency is important to enhance the understanding and comparability of different ESG ratings products. We propose an addition to section two of Annex III to include transparency regarding the data source(s) for each relevant KPI, whether it is based on reported or estimated data, and the time stamp to which the data point relates. Transparency should also be provided regarding the use of controversies in ESG ratings.

AFME strongly supports the proposed requirement that ESG rating providers shall take steps that are adequate to ensure that fees charged to the users of the ratings are fair, reasonable, transparent and non-discriminatory. This principle should also extend to fees charged to rated entities. However, for additional rigour and precision, it should be specified that users must receive sufficient and clear information on fees and pricing drivers from ESG Rating Providers to be able to make informed choices. Furthermore, as highlighted for Credit Ratings Agencies, the principle should not only apply to ESG ratings products but also the ancillary services of ESG ratings providers. ESG rating providers also commercialise research/data which allow them to explain their rating. As it stands, the text only covers the rating itself, yet users need information on the basis of the rating in order to understand it (i.e., research and basic data, which are billed as such by the agencies). The risk of not covering these services is that the cost of the rating agencies' services will be turned on to these related services. This would render the provision ineffective in achieving its objective (i.e., to avoid an unjustified and opaque explosion in the cost of ESG ratings for users). In order to ensure an efficient implementation of those principles, ESMA could detail the requirement with regard to fees charged by the ESG rating providers for the ESG ratings, the data and related research, as they did for credit rating agencies.

While AFME supports the proposed complaints-handling mechanism (ex-post), we believe that requiring ESG ratings providers to have regular conversations (ex-ante) with rated companies would enhance the quality of ESG ratings and increase transparency.

Independence and avoiding conflicts of interest

AFME supports the proposed requirements for ESG rating providers to have in place robust governance arrangements as set out in Article 23. With respect to addressing potential conflicts of interests, we do not consider that it is necessary to prohibit ESG rating providers from providing the other activities specified in Article 15(1). While it is important that effective processes are in place to identify and manage any such potential conflicts of interest, mandatory separation may not be necessary and could increase costs for users of ESG ratings products. We therefore propose that article 15 is unnecessary given the proposed powers for ESMA to require ESG rating providers to take measures to mitigate the risk of conflicts and where the risk cannot be adequately managed, to require the providers to separate activities as proposed in article 23.

AFME supports the proposed transparency requirements in articles 21 and 22. We support the focus on transparency of methodologies and the proposed article 26 confirming non-interference with the content of ratings or methodologies. This is important to promote innovation and competition in the market.

Effective interactions between ESG Rating Providers and rated entities

As recognised in the IOSCO Report and Recommendations (see IOSCO Recommendations 8 and 9), it is important to ensure efficient and effective interactions between ESG Rating Providers and rated entities. This has also been reflected in, for example, the draft UK Code of Conduct[3]. AFME believes that the proposed regulation should also include provisions to promote effective interaction between ESG rating providers and covered entities. This should in turn enhance the quality and reliability of ESG ratings. We propose the addition of the following provision to achieve this:

New article:

(1) Where an ESG Rating Provider collects information from a rated entity on a bilateral basis, or through questionnaires, it should:

a. communicate sufficiently in advance when it expects to request information for the purposes of assigning or updating the ESG rating and data products; and

b. include in its requests, pre-inputted information either from publicly available sources or from the rated entity's previous submissions for the rated entity's review or confirmation.

(2) ESG Rating Providers should:

a. assign an analyst (with name, contact number and email) as a consistent contact point with whom the rated entity can interact to address any queries relating to the ESG rating assessment;

b. expeditiously inform the covered entity of the principal grounds on which the ESG rating is based, before the publication of the ESG rating; and

c. allow the rated entity time to draw attention to any factual errors, including the data and information underlying the ESG rating before the publication of the ESG rating report.

Furthermore, we consider that the use of controversies should be a particular focus where systems and controls are required alongside greater engagement with rated entities. Experience of members as rated entities is that controversies can have a significant weighting on overall ratings, often based on media reports which may not be reflective of actual impacts, often leading to incorrect interpretation with a lack of opportunity for rated entities to correct or respond. In addition to transparency over the methodology, we support the introduction of provisions requiring ESG rating providers to apply a due diligence process with

[3] See principle 6 of draft DRWG Code of Conduct https://www.irsg.co.uk/assets/Papers/DRWG-ESG-Code-of-Conduct-Draft-July-2023.pdf

respect to controversies, in order to (i) assess the sources and seriousness of controversies, (ii) to give a right of response to the rated entity and (iii) to give due consideration to remedial measures taken by the rated company and the time elapsed since the occurrence of a controversy.

Third country regime

It is important that the regulation provides a workable third country regime that supports access of EU users of ESG ratings to ESG ratings produced by providers located outside the EU. We are concerned that the proposed third country regime is unlikely to be workable in practice and will result in similar challenges to those experienced in the context of the third country regime for financial benchmarks, given the ongoing challenges with implementing that regime[4] as expressed by the Commission in its Report released on 14 July 2023.

We strongly encourage the co-legislators to put in place a workable and flexible arrangement that would avoid unnecessary fragmentation and provide appropriate deference where third country ESG ratings providers are subject to regulation which seeks to implement the IOSCO Recommendations in a way that complies with EU objectives. We also consider that third country ESG ratings providers should have the flexibility to either seek endorsement or recognition regardless of their size.

We provide the following observations on each of the proposed third country routes for ESG ratings:

Equivalence:

Whilst adoption of the IOSCO Recommendations for ESG data and ratings is starting to take effect in other global jurisdictions, only the EU and UK are currently proposing a broad licensing regime (noting that the Indian regime is narrow in scope). Therefore, the equivalence route is unlikely to be available, at least beyond the UK, in the foreseeable future.

Recognition:

The legal representative of a third country ESG ratings provider is expressly appointed by that third country provider to act on its behalf with regards to the third country provider's obligations under the proposed ESG ratings regulation. The requirement for oversight of the third country provider's businesses creates a challenge for third party legal representatives given their accountability to ESMA. Therefore, the trend in the context of BMR has been for a legal representative to be an EU entity within the third country provider's group (and even then, there are challenges in terms of how the legal representative has access to the information it needs). Members query whether this will be feasible under the ESG ratings proposal to the extent ESMA expects the legal entity to comply with the separation of business functions under Article 15.

Endorsement:

We note that under the proposed ESG ratings regime, an EU ESG ratings provider can only endorse ESG ratings provided by third country ESG ratings providers belonging to the same group (Article 10(1)). Therefore, the proposals do not seem to envisage that a third party endorsing entity would be permissible. We also note that endorsement may be required for each individual rating, which is likely to be impracticable.

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[4] REPORT on the scope of Regulation (EU) 2016/1011, in particular with respect to the continued use by supervised entities of third-country benchmarks and on potential shortcomings of the current framework

About AFME

The Association for Financial Markets in Europe (AFME)[5] represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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