EFAMA

European Fund and Asset Management Association

EFAMA's RESPONSE TO IOSCO´s CONSULTATION ON ESG RATINGS AND DATA PRODUCTS PROVIDERS

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EXECUTIVE SUMMARY

Given the increasingly important role ESG ratings and data products providers play in investment processes, EFAMA welcomes the increased attention of regulators to this issue. In light of the growing regulatory scrutiny on the ESG characteristics of potential investments, improving the usability and reliability of the ESG ratings and data products is a key priority for the European asset management industry. EFAMA therefore supports IOSCO's recommendations that national regulation investigates this market more closely to address the lack of transparency of ESG providers' methodologies and pricing policies, data governance and data quality, and the management of potential conflicts of interest.

EFAMA recommends that regulators and ESG ratings and data products providers focus their attention on:

1. **Improving the transparency around ESG ratings methodology and ESG data products –** The usability of ESG ratings and data products by asset managers remains greatly limited by the lack of transparency in the types of data and methodologies on which providers base their products. EFAMA encourages providers to develop common industry standards and codes of conduct to enhance their disclosures on data collection and an ESG ratings/scorings methodology. While allowing for enough flexibility for providers to use a wide range of methods and approaches, third-party providers should offer full disclosure of the methodologies used and their data sources. This would improve the comparability of the providers' ESG data products and allow asset managers to understand how they compare across companies and sectors.

2. **Ensuring robust and transparent governance processes to avoid potential conflicts of interest -** To preserve market integrity, EFAMA encourages ESG ratings and data products providers to develop and adopt best practices codes on identifying, managing, and disclosing conflicts of interest. More specifically, EFAMA believes such a code of conduct is necessary when a provider performs consulting services for companies subject to its ESG ratings and products services.

3. **Addressing the pricing and licence power of ESG ratings and data products providers –** The increasingly high market concentration of ESG data, coupled with the growing need for ESG data from asset managers, has given providers the ability to charge considerably high fees. This spike in the ESG data products cost is particularly detrimental to smaller firms and ultimately affects end-investors. We therefore urge regulators to consider the pricing policies applied by data providers and to take actions to enhance fee transparency and fee justification.

4. **Alleviating the data gap by introducing global ESG company reporting standards and establishing the proposed European Single Access Point for ESG data –** EFAMA urges regulators to improve the availability of ESG data and the consistency in non-financial company reporting. We believe the CSRD review will help to close the data gap and result in more meaningful, comparable and reliable ESG disclosures on investee companies. We also encourage regulators to implement the proposed European Single Access Point, leveraging on digitalisation, to help overcome the current dependency of data users on commercial data providers.

IOSCO RECOMMENDATIONS AND EFAMA RESPONSES

Proposed Recommendations on possible regulatory and supervisory approaches

Recommendation 1: Regulators may wish to consider focusing more attention on the use of ESG ratings and data products and ESG ratings and data products providers in their jurisdictions.

The use of ESG ratings and data products has significantly increased in recent years, and given the lack of publicly available information, asset managers are heavily reliant on third-party providers. With the increasing regulatory focus on the ESG characteristics of potential investments, coupled with the growing demand from investors for sustainable financial products, the investment management industry's need for ESG ratings and data products will continue to grow at pace over the coming years in Europe.

Although we acknowledge that market research providers and sustainability rating agencies have increased their efforts to collect and analyse data on ESG performance in recent years, ESG ratings still present several challenges for asset managers in assessing the true sustainability of securities, funds, and mandates. We believe that further improvements are necessary to facilitate sustainable investments and achieve the objectives of the EU Green Deal.

EFAMA welcomes the IOSCO recommendations on increased transparency for ESG assessment processes and management of conflicts of interests. We strongly encourage providers to adhere on a voluntary basis to the key action points put forward by IOSCO and to follow the following objectives:

- **Improving transparency of the methodologies used by providers and the sources of data** - As highlighted in the IOSCO report, the usability of ESG ratings and data products by asset managers is greatly limited by the lack of transparency in the types of data and methodologies providers have based their ratings/scorings on. In fact, rating methodologies vary considerably among providers, and the correlation between ESG scores from different data providers for the same company is often very low. While a certain level of divergence is appreciated by investors, reflecting different calculation approaches and differences in industry/sectors, there is also a necessity to provide more transparency on the methodologies used. Without it, asset managers are unable to ascertain that the information provided can be safely relied on in the context of their investments and product development strategies. There is also a parallel issue concerning data collection methods, with asset managers not receiving a clear picture. As a result, increased transparency in methodology alone is unlikely to significantly increase the comparability of the ESG scores and ratings from different providers. Indeed, there are considerable areas of variability in the data used, which is often sourced from bespoke company questionnaires placing different emphasis on ESG policies. In addition, providers do not disclose which data has been obtained directly from investee companies and which data has been estimated. The estimation methodologies are also very opaque. As a result, asset managers cannot properly compare the core ESG data underpinning each suppliers' services. Therefore, we support the development of voluntary common industry standards and best practice codes to improve the transparency of the data collection methods and ESG ratings/scorings methodologies. These could be reviewed periodically, taking into account the evolution of market developments as well as the sustainability reporting requirements. A decision could be made at a future stage as to whether further regulatory initiatives are required. We also recommend that IOSCO encourages more consistency in the way providers collect ESG data, as well as the development of a common set of quantifiable critical data elements that would be consistent with the existing framework for company disclosures. This would improve the comparability of the providers' ESG data products and would allow asset managers to understand how they compare across companies and sectors.

- **Ensuring appropriate management and disclosure of potential conflicts of interest -** We also support the development of voluntary best practice codes regarding the management and disclosure of conflicts of interest by ESG ratings and data products providers. EFAMA members share the concerns raised in the IOSCO Report, especially in situations where an ESG ratings and data products provider performs consulting services for companies that are also subject to its ESG ratings and products services. In fact, a provider delivering both ESG research and ESG labels is likely to base the labels on its own research and thus risk prejudicing the rating of other funds that adopt a different approach. To preserve market integrity, we encourage ESG ratings and data products providers to develop and adopt best practice codes on how to adequately identify and manage conflicts of interest in these specific cases. For instance, this could include procedures at the provider level to ensure the independence and separation of ESG ratings and data products services and the consulting services (i.e. separation of staff).

Second, EFAMA encourages regulators to address the issues related to the increasing market concentration of ESG data, and more particularly, the rising cost of ESG data services. As the IOSCO Report rightfully highlights, the market is dominated by a handful of powerful providers who control a substantial market share. This growing oligopoly gives these global providers substantial market power and the ability to set excessively high fees. This spike in cost of ESG data services is particularly detrimental to smaller firms with less resources and bargaining power, and ultimately affects end-investors. Members have also expressed concerns regarding the lack of transparency in the pricing and licensing frameworks, which largely depend on the combination of data modules and the size of ESG assets under management of the clients. We therefore encourage ESG ratings and data products providers to develop voluntary guidelines to improve the transparency of pricing and licensing frameworks. It is also of utmost importance that supervisory authorities gain a better overview of the costs and revenues charged to identify possible violations of the non-discrimination and cost-based/cost-related principles laid down in the various national regulations. For instance, policymakers could collect annual information on pricing, licenses, costs and revenues per types of ESG ratings and ancillary services in addition to fees and costs for rating related products and services sold by other entities within the group. Collecting such information would lead to a better understanding of the services provided by rating agencies and their entities within the group.

In collaboration with ICSA (International Council of Securities Association), EFAMA has published a Global Memo on Benchmark Data Costs (June 2021) that identifies the main challenges arising from the increased use of financial benchmarks and indices (including ESG benchmark) over recent years and the imposition of increasingly complex and overpriced data licences. Our paper also makes a series of recommendations to ensure that benchmark data is made available to users at a fair price. We believe some of these recommendations related to benchmark data prices also apply in the context of this consultation, including notably:

- Regulators should ensure that all administrators of benchmarks and indices take adequate steps to guarantee that licenses of, and information on, benchmarks are provided on a fair, reasonable, transparent and non-discriminatory basis to all supervised entities;

- Any benchmark data license costs should in principle be based only on the incremental/marginal cost of providing/distributing a given data service plus a reasonable profit margin;

- National Competent Authorities and users should have access to adequate written information to ensure transparency on costs and prices, and reduce disputes related to licensing fees.

Finally, we urge regulators to introduce common standards for ESG reporting by companies

and implement the proposed European Single Access Point (ESAP) to reduce the reliance of asset managers on providers in Europe. A common framework for ESG company reports would lay the foundation for uniform metrics and reporting standards and significantly improve the quality and availability of ESG data. This framework should reflect – to the greatest extent possible – the prevailing international standards for reporting of non-financial information to be set up by the ISSB and should apply to all regulatory-imposed ESG data needed by asset managers. These include information on sustainability risks and opportunities, adverse impact effects of a company's business activities and Taxonomy-relevant data. All ESG data should be made free and publicly available in a machine-readable format by implementing the proposed ESAP. As stated in previous position papers (EFAMA response to Commission consultation on establishment of European Single Access Point (ESAP) | EFAMA), a free and publicly accessible data platform for comparable and consistent ESG information on companies would greatly help overcome the current dependency of data users on commercial data vendors.

Proposed Recommendations on the internal processes of ESG ratings and data products providers

Recommendation 2: ESG ratings and data products providers could consider issuing high quality ESG ratings and data products based on publicly disclosed data sources where possible and other information sources where necessary, using transparent and defined methodologies.

As stated in our comments on Recommendation 1, we strongly encourage ESG ratings and data products providers to offer more transparency regarding the sources and types of data and the methodologies used, especially when the ESG assessment does not rely solely upon publicly disclosed data sources. This would enable asset managers to ensure the information provided can be safely used in the context of their investment decisions and product development strategies and would significantly enhance the comparability, reliability and usability of the providers' products.

We also encourage ESG ratings and data products providers to consider committing to high quality ESG ratings and data products. In addition to IOSCO's suggestion for providers to ensure their methodologies are subject to regular reviews and to some form of validation based on historical experience, EFAMA encourages providers to consider the following:

- **To commit to an adequate update frequency of ESG data products**- Members have highlighted that the low frequency of updates affects investors' ability to use voting as a tool to drive companies' ESG behaviour in a timely manner. Given the pace of change in the ESG space, we believe that the current minimum required update of once a year is insufficient and argue that a minimum of two updates per year should be set. We also encourage more transparency regarding the update cycle for each aspect of the ESG ratings and data products. This information should be available for each company covered and allow investors to know when each part of the analysis was last updated. Finally, another major limitation asset managers see from providers today is the lack of provision of data in fiscal/time series format, which makes compliance with reporting regulations difficult.

- **To improve communication with users (such as asset managers)** – An additional issue identified by members is the distinct lack of communication between the ESG rating providers and the manufacturers of the investment products that are rated. Proper communication should ensure that the methodologies used, as well as changes to the methodologies, are made transparent to the clients. This would also ensure that changes in the methodologies are properly incorporated in the product development strategies and that the investors understand the impacts on products. Better communication would also allow clients to flag any errors to providers on time.

- **To incorporate the regulatory changes into their framework** – to facilitate asset managers' ability to keep up with the different ESG requirements.

Recommendation 3: ESG ratings and data products providers could consider ensuring their decisions are, to the best of their knowledge, independent and free from political or economic pressures and from conflicts of interest arising due to the ESG ratings and data products providers' organizational structure, business or financial activities, or the financial interests of the ESG ratings and ESG data products providers' employees.

Recommendation 4: ESG ratings and data products providers could consider, on a best efforts basis, avoiding activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of the ESG rating and ESG data products provider's operations or identifying, managing and mitigating the activities that may lead to those compromises.

EFAMA strongly encourages the development of robust and transparent governance processes around the conflicts of interest policies at the level of ESG ratings and data products providers. Asset managers must be able to ensure that third-party providers' decisions are independent and free from any political or economic pressures and conflict of interests.

As stated in our comments on Recommendation 1, the offering of a broad range of products and services by third-party providers, combined with the high-market concentration for ESG information, raises concerns regarding potential conflicts of interest. To preserve market integrity, we would support the development of voluntary codes of conducts for ESG ratings and data products providers to ensure conflicts of interest are adequately identified and managed in these specific cases. For instance, this could include procedures at the level of the provider to ensure independence and separation of ESG ratings and data products services and the consulting services (i.e. separation of staff).

Recommendation 5: ESG ratings and data products providers could consider making high levels of public disclosure and transparency an objective in their ESG ratings and data products, including their methodologies and processes.

Mandating transparency in methodologies would positively enhance the comparability and reliability of ESG ratings and data products. However, transparency alone is unlikely to lead to significant convergence in those products. As stated in our comments on Recommendation 1, there are considerable areas of variability in the core ESG data underpinning each suppliers' services. This can mainly be explained by some fundamental divergences between the bespoke company questionnaires used to collect data from companies and the different methodologies used for estimated data. Therefore, we would encourage providers to develop a common approach to data collection and require suppliers to differentiate between actual and estimated data.

Another drawback of ESG scores is linked to the nature of the data used by providers. Like credit ratings, the information that ESG scores provided is backward oriented and does not allow for a forward-looking assessment of ESG risks and opportunities.

Recommendation 6: ESG ratings and data products providers could consider maintaining in confidence all non-public information communicated to them by any company, or its agents, related to their ESG ratings and data products, in a manner appropriate in the circumstances.

EFAMA supports IOSCO's recommendation to reinforce the level of protection of non-public information, especially as we expect a large number of new entrants into the ESG data services sector. We also suggest that appropriate procedures must be developed to keep track of any non-public information internally.

Proposed Recommendations concerning the use of ESG ratings and data products

Recommendation 7: Financial market participants could consider conducting due diligence on the ESG ratings and data products that they use in their internal processes. This due diligence could include an understanding of what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used.

Asset managers in the EU are already required to ensure proper due diligence of third party providers under the MiFID II Delegated Regulation (Delegated Regulation (EU) 2017/565). EU-based investment funds are obligated to undertake due diligence of any data, research and analytical resources they rely upon in order to be confident that investment managers can validate their reason for holding specific investments to meet their sustainability objectives. In addition, EU-based investment management companies are obliged to establish and implement written policies and procedures on due diligence to ensure that investment decisions are carried out in compliance with the investment fund's investment strategy and risk limits, which include ESG risks.

There, we believe that the existing regulatory frameworks regarding outsourcing and due diligence are sufficient and believe that some best practice quidelines on this area, as opposed to additional rules, could be developed. For example, financial market participants could be advised to use data samples to gain an understanding of the quality of the datasets used by different ESG suppliers. The outcomes of such analysis will help compare the data values between suppliers and help inform the extent of the variability between the different suppliers. This, however, would require greater transparency from providers regarding their methodologies, particularly when machine learning and AI is used in the model.

Proposed Recommendations concerning the interactions of ESG ratings and data products providers with entities subject to assessment by ESG ratings and data products providers

Recommendation 8: ESG ratings and data products providers could consider improving information gathering processes with entities covered by their products in a manner that is efficient and leads to more effective outcomes for both the providers and these entities.

Recommendation 9: ESG ratings and data products providers could consider responding to and addressing issues flagged by entities covered by their ESG ratings and data products while maintaining the objectivity of these products.

EFAMA supports IOSCO's recommendation for ESG ratings and data products providers to improve their information gathering processes and to put in place mechanisms to ensure

regular and consistent communication with the covered entities.

Due to the lack of publicly available data, ESG ratings and data products providers often rely on data sources from bespoke company questionnaires. However, members have reported that providers' ESG information gathering processes are insufficient to ensure high-quality data, with covered entities having to complete an overly high number of different questionnaires per year. Therefore, we agree that ESG data suppliers should be encouraged to adopt a common approach to sourcing company ESG data to reduce overhead and improve the quality and consistency of the data sourced.

Finally, we agree that a formal feedback mechanism is needed between covered entities and ESG suppliers with recourse provisions in the ESG provider firms ensuring the ability to escalate to the Competent Authority.

Recommendation 10: Entities subject to assessment by ESG ratings and data products providers could consider streamlining their disclosure processes for sustainability related information to the extent possible, bearing in mind regulatory and other legal requirements in their jurisdictions.

EFAMA supports IOSCO's recommendation for covered entities to streamline their disclosure processes for sustainability-related information. Non-financial information currently publicly disclosed by companies does not adequately meet the needs of the intended users and is not sufficiently comparable. As stated in our comments on Recommendation 1, EFAMA welcomes greater convergence of ESG reporting standards - under the CSRD review and the international standards for reporting of non-financial information to be set up by the ISSB - as well as the proposed creation of a European Single Access Point (ESAP).

In addition, we believe a positive step would be to survey a sample of large covered entities and ask for their feedback as to the number and types of ESG supplier questionnaires they have to fill. Their input could support the development of a common set of consistent ESG metrics that could be published on their websites and company reports.

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About EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 27 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

More information is available at www.efama.org.

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