CONSULTATION RESPONSE

Brussels, 1 September 2023

BRINGING ESG RATINGS AND ESG DATA PROVIDERS WITHIN THE REGULATORY PERIMETER

Policy Objectives

The proposal is structured to address the issue of transparency in ratings, particularly in the context of Environmental, Social, and Governance (ESG) ratings. The main points are:

- Improved transparency. The proposal aims to enhance transparency by providing clearer information about the characteristics, methodologies, and data sources used in generating ratings. This is meant to help users better understand how the ratings are developed and allow for more informed investment decisions.

- Understanding rating providers' operations. Alongside increased transparency, the proposal seeks to gain a clearer understanding of how rating providers operate. This includes their internal processes, assessment criteria, and potential biases.

- Concerns from industry stakeholders. The Impact Assessment has identified concerns from industry stakeholders, especially benchmark administrators, who utilise particular ratings but lack certainty about how those ratings are developed. This uncertainty could affect their confidence in using the ratings for benchmarking purposes.

- Outdated or inaccurate data. The proposal acknowledges that ESG ratings can be hindered by the use of outdated or inaccurate data as the basis for ratings. This can have significant implications, as inaccurate ratings may misrepresent the sustainability or social responsibility of rated entities, impacting their ability to attract capital or investments.

The overall goal of the proposal it to promote greater transparency, reliability, and accuracy in ESG ratings, to enable more informed decision-making and facilitate a fair and efficient allocation of capital based on a company's environmental, social, and governance performance.

Relevance to the European Investment Management Industry

Environmental, social, and governance (ESG) considerations are vital factors in asset managers' investment decisions. First and foremost, there is a growing understanding that ESG considerations can have a significant impact on a company's financial success, long-term viability, and consequently investment returns. Second, there is a constantly growing demand from investors, both retail and institutional, for investment products/solutions that incorporate ESG factors. Third, there are regulatory requirements in Europe such as the Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD), EU Taxonomy Regulation, and Shareholders Rights Directive (SRD II) aimed to strengthen ESG reporting, disclosure, and engagement practices, as well as legislative frameworks (UCITS and AIFs) that aim to integrate ESG considerations into the established investment processes. Therefore, those regulations, in addition to market trends, require asset managers to consume and analyse an extensive amount of ESG data and be able to rely on them.

As a direct consequence of these developments, we welcome the efforts of a number of ESG Data Providers, as well as ESG Rating Providers, to collect and analyse data and provide ESG ratings to investors. However, despite this increasing coverage, the current data landscape still confronts asset managers with substantial challenges when trying to assess the true sustainability of their investments – with the risk for EU asset managers being held liable vis-à-vis clients as well as regulators – while their ESG assessments are based on external data and ratings whose providers, in turn, are not sufficiently regulated to secure asset managers' own duties. Therefore, in our view, it is necessary to make prompt improvements in these aspects to provide asset managers, and thus investors, with legal certainty when using ESG data and ratings. **A regulatory framework covering the provision of ESG data and ratings is likely to reduce the risk of unintended greenwashing, as well as contain the risk of misled investment by asset owners and investors.**

Challenges and opportunities

What are the key elements of the legislative proposal/policy initiative that we support:

EFAMA welcomes that the measures included in the proposal will lead to a **significant enhancement in the transparency surrounding ESG (Environmental, Social, and Governance) ratings.** This newfound transparency will be primarily focused on shedding light on various critical aspects. This includes their objectives, inherent characteristics, employed methodologies, and the data sources that contribute to their assessments. Importantly, this push is designed to uphold the concept of methodological freedom by striking a balance between allowing ESG rating providers the flexibility to choose and implement their methodologies while ensuring the utilisation of relevant metrics.

First, we appreciate the improved clarity that the proposal will bring to the operations of ESG ratings providers. This includes **measures relating to independence and conflicts of interest of ESG ratings providers**, which if not covered have the potential to compromise the integrity of the ratings they provide. By defining stringent requirements to ensure independence and identify and mitigate such conflicts, the proposal aims to boost the credibility of ESG ratings and enhance the overall trust in the wider ESG ecosystem.

Second, we emphasise the significance of establishing a comprehensive and transparent **mechanism for handling complaints related to ESG ratings**. Such a mechanism would provide individuals and entities with a clear avenue to voice their concerns, fostering accountability and rectification within the industry.

Third, the proposal also introduces the **concept of fair, reasonable, transparent, and non-discriminatory fees in the ESG ratings landscape.** This aspect is meant to ensure that the cost structures associated with these services are aligned with the value they provide. Additionally, the proposal empowers the European Securities and Markets Authority (ESMA) to intervene in instances where violations of these fee principles occur, bolstering necessary regulatory oversight.

Last, we support the existence of a regulatory and supervision regime, with authorization and registration requirements, as well as organizational requirements for strong operational processes, internal control, and governance frameworks. Indeed, we believe that these conditions are essential to enhance the integrity and reliability of the ESG ratings market and hence reduce the risk of unintended greenwashing. That said, we believe there needs to be certain proportionality embedded to avoid unintended consequences in particular for smaller providers and new entrants (i.e. these leaving/not entering the market as they are not able to support registration fees and requirements) and, consequently, reducing the choice for ESG ratings users. Additionally, the market for ESG ratings and ESG data is highly concentrated and dominated by non-EU players, it is of the utmost importance that critical third-country providers operating in the EU are also subject to the EU regulatory and supervision regime.

Overall, *EFAMA supports the proposal's intention to create a more transparent, accountable, and balanced ESG ratings ecosystem. The suggested measures aim to strengthen investor confidence, ensure integrity, and drive the continued growth of sustainable and responsible investment practices.*

Areas for further improvements

Acknowledged all the potential improvements, we still believe that there is room for improvement to foster even more clarity and transparency for financial market participants as well as end investors.

1. Inclusion of ESG raw data gathered and disseminated as well as ESG data products built by providers

We firmly support a regulatory framework covering ESG ratings. However, we consider it crucial that the legislation covers both ESG ratings and data providers, as requested by IOSCO at the global level, bearing in mind that a proportional approach shall be adopted to prevent regulatory requirements to avoid stifling innovation.

Within the realm of investment decisions and regulatory reporting, it is imperative to have robust and reliable data to support these processes. Given the vast number of investee entities and data points, the absence of a comprehensive public database poses a severe challenge for our industry. Although the introduction of the Corporate Sustainability Reporting Directive (CSRD) and the European Single Access Point (ESAP) in the EU partially addresses this issue, a significant portion of ESG data users still relies on purchasing ESG data services to access the necessary information and will keep doing so for several years coming, as EU-based asset managers need all types of ESG data also at the global level. Furthermore, unlike financial data, ESG data currently lacks standardised international reporting and audit standards. While there are ongoing initiatives to establish such standards, achieving broad coverage in terms of reporting entities, common definitions, and data points will take time. This situation often necessitates the use of proxies and estimates, underscoring the importance of transparent methodologies not only for ESG ratings but also for ESG data (including estimates). **Therefore, we believe it is of the utmost importance that raw data even in the absence of an assessment (i.e., opinion, model, etc.) should be in scope of the legislative proposal**. In fact, we can confirm the market currently suffers from insufficient integrity and reliability. Moreover, ESG ratings are mainly sourced from ESG data, hence they should not be disassociated as the quality of ESG ratings depend on the quality of ESG data. This issue was also covered in the IOSCO report which reiterated that for all data, including raw data, estimated data, and controversies alerts, users need equal assurance that the organizational, process, and internal control framework is robust enough. In addition, we operate in a market that is either very concentrated in terms of providers or different providers offering different data coverage; in this context, it is not only costly but also quite challenging for users, such as asset managers and institutional investors, to change a data provider. Besides data processing, quality, and internal control policies, transparency requirements on raw data should rather be minimal given the absence of assessment/opinion. It could be limited to the information already required in Annex III (1b) and (2b) – but extended to data in general, not just those used for the ESG ratings.

Since ESG data and ESG ratings are of complementary nature, it is crucial to address both aspects simultaneously and not only ESG Data embedded in ESG Ratings. Enhancing the quality and transparency

<u>of ESG data and ratings should be pursued hand in hand. This approach ensures that investors and regulators have access to reliable information, promotes informed decision-making, and fosters trust in the wider ESG ecosystem.</u>

2. Clarification of the definition proposed by Article 3 concerning the definition of ESG ratings and data

The precise meaning of the term "ESG rating" remains ambiguous. According to Article 3, an ESG rating *means an opinion, a score, or a combination of both, regarding an entity, a financial instrument, a financial product, or an undertaking's ESG profile or characteristics or exposure to ESG risks or the impact on people, society and the environment, that are based on an established methodology and defined ranking system of rating categories and that are provided to third parties, irrespective of whether such ESG rating is explicitly labelled as 'rating' or 'ESG score'.* We, therefore, would like to suggest that the definition should take into account IOSCO's guidelines and be articulated as follows:

> *"ESG ratings": refer to the broad spectrum of ratings products that are marketed on a commercial basis (i.e. for a charge) as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labelled as "ESG ratings".*

Given the necessity to bring clarity also on the ESG data spectrum, it could also be considered to include "ESG data products", in which case this would need to be clearly delineated from ESG ratings. Any such reflections would need to bear in mind that "ESG data products" is **<u>not</u>** any information about companies used in an ESG context: For example, using R&D spending in proprietary ESG tools or statutory tax rates for different countries should not be considered as ESG data products simply because they are used in context of an ESG/sustainability assessment.

A starting base could be the IOSCO-based definitions of ESG ratings and ESG data products, which clearly outlines that the definition covers those ratings and data products that are "*marketed*" as end-products by providers for a charge. This limitation makes sense, as the payment made by users for ESG data and ratings must secure the quality and reliability of what is delivered to them by these providers.

3. Clarification for ESG ratings produced by regulated financial undertakings (article 2(2)(b))

EFAMA welcomes the exclusion foreseen by Article 2(2)(b) for "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" as financial undertakings are already subject to robust requirements under the sustainable finance framework (e.g. SFDR, Taxonomy, etc.).

That being said, the article is not sufficiently aligned with the already existing disclosure requirements. Financial market participants (FMPs) are already required to disclose certain information about financial products publicly in their precontractual, periodic, and website disclosures. One such element pertains to the sustainable investment percentage. This percentage, which reflects the extent of sustainable investments, is determined using the methodology of each individual financial market participant. It is intended for external dissemination (appearing in financial product documentation) and therefore might be unintentionally included in the proposed regulation's scope. However, the FMPs themselves are subject to various disclosure requirements stipulated by the SFDR. For instance, within the context of entity-level reporting for the Paris Agreement objectives, financial market participants are obliged to reveal the methodology and data employed for gauging their adherence or alignment with the Paris Agreement objectives. **With this in mind, it is our view that article 2(2)(b) should be clarified to exclude any**

ratings, scores, or data that financial market participants could furnish to clients and/or prospective clients, as these are already addressed by other regulatory frameworks. In fact, within the context of SFDR website product disclosures, FMPs address two distinct aspects of data: the sources and processing of data, as well as the constraints inherent in methodologies and data usage. Imposing additional disclosures on these entities would be disproportionate, given that they are already subject to these stringent requirements both at entity-level and product-level. Moreover, for FMPs, the end product is the financial product they produce not the proprietary scores/ratings. The proprietary scores/ratings pertaining to underlying investments serve as a mechanism to achieve the final product and are not commercially sold in themselves. We believe that the exclusion of ratings used "for providing in-house financial services and products" covers this scenario. However, the term "in-house", which we believe is used to capture proprietary models, could be misleading and lacks additional clarity.

In addition, global asset management firms can share proprietary ratings within their groups with other entities (EU or non-EU). This should be explicitly excluded.

Proposed amendment: Article 2(2)(b):

"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,* ***or*** *required by other regulations applicable to EU regulated financial undertakings, services or products,* ***or*** *provided to other entities of the same group or disclosed open source and/or free of charge."*

4. Enhanced transparency requirements on fees

We welcome the Commission's proposal to impose fair, reasonable, transparent, and non-discriminatory treatment of users of ESG ratings. Fees charged for ESG ratings services shall not depend on the level of the ESG ratings issued by the ESG ratings provider or on any other result or outcome of the work performed. This is consistent with the rules for credit rating agencies. Furthermore, we believe that the proposal should be more specific by including the fees grid in the scope. In fact, some large ESG Data or Rating Providers are already able to provide Fee Grids/Pricing Lists, while other large ones keep their fees totally un-transparent to their clients – creating both a permanent as well as unexpectable fee inflation for users.

The same request should apply to ESG data products, as the same issues are faced by clients both vis-à-vis ESG data product providers and vis-à-vis ESG ratings providers, as long as such providers deliver their services on a commercial basis.

5. Enhanced transparency on ESG ratings provision contracts

From EFAMA's perspective, fostering the growth of an open and competitive ESG ratings market requires enhanced transparency. This transparency principle should extend beyond the requirements imposed by Article 25, as it should also encompass the commercial and contractual aspects of ratings provisions other than fees. We recommend establishing a general regulatory framework for contracts related to ESG ratings provisions that could include essential elements of contracts that ESG ratings providers must adhere to. This regulation could address the following points, for instance:

- Granting ESG ratings users the right to share a portion of this data with their investors, other relevant entities that have entrusted the delivery of a service based on the pertinent ESG ratings user, and the custodian, solely to fulfil their legal obligations.

- Defining the scenarios under which ESG ratings providers can mandate users to incorporate legal notices or disclaimers in their contractual agreements, informational materials, and so forth.

Presently, benchmark, credit, and ESG ratings providers stipulate extensive legal notices in their contracts, which users might not always be able to supply, resulting in breaches of contract**.**

We believe that this contractual unbalance should be addressed by the legislator and the contractual relations between the Providers and the Users could be addressed based on Article 30 of the Digital Operational Resilience Act (DORA), as it covers a similar issue.

6. Strengthening transparency requirements in Annex III

We believe the transparency requirements, whilst already exhaustive, could still be further strengthened and aligned with IOSCO recommendations. We propose the following amendments (in bold):

- On (b) data sources, including if they are public or non–public, and if they are sourced from sustainability statements required by Directive (EU) 2022/2464, estimation of input data or **use of industry averages** in case of unavailability, frequency of data updates)

- On (g), within the E, S or G factors, specification of the topics **and issues** covered by the ESG rating/score, **the KPIs used and measurement methodologies underlying each KPI** and whether they correspond to the topics from the sustainability reporting standards developed pursuant to Article 29b of Directive 2013/34/EU

- Disclosure should also be made regarding **the scope of business activities that is covered by the assessment and which part(s) of the group (if the entity is part of the group) are included and also time horizon of the assessment.**

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages about 28.5 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 EFAMA Fact Book.

More information is available at www.efama.org

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