

ESG rating activities

Achieving an efficient European regulation

Paris Europlace & Institut de la Finance Durable Position Paper

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Paris Europlace is the organization in charge of promoting and developing the Paris financial center. We are a privileged intermediary of European and French authorities, with which we maintain a continuous and constructive dialogue. Our aim is to promote financial markets to international investors, issuers and financial intermediaries to better finance the real economy and the energy transition. Paris Europlace gathers more than 600 members, including investors, sustainable finance entities, banks, financial market authorities, corporates, consulting firms.

“L’Institut de la Finance Durable” (IFD - Paris Sustainable Finance Institute) is the branch of Paris Europlace dedicated to sustainable finance. It aims to coordinate and accelerate the action of the Paris financial center to achieve the energy and environmental transition. Both Paris Europlace and the Institut de la Finance Durable contribute to mobilizing Paris-based market players towards a sustainable and low carbon economy, in line with the objectives of the Paris agreement.

As an integral part of its Renewed Sustainable Finance Strategy of July 2021, the European Commission (EC) adopted on June 13th, 2023 a proposal for a “**regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities**”¹.

This proposal stems from the fact that “*currently, ESG ratings do not sufficiently enable users, investors and rated entities to take informed decisions as regards ESG-related risks, impacts and opportunities. As a consequence, confidence in ratings is being undermined*”². Therefore, establishing a solid framework has become a necessity as the market of ESG ratings and data products has been rapidly growing over the past few years and it is expected to continue expanding over the coming years.

By addressing the issue related to ESG ratings through a regulation, and not solely a Code of Conduct, the European Commission shows its willingness to strengthen the reliability and the comparability of ESG ratings within the EU through hard law, and paves the way as a leader on the international scene in this respect.

Paris Europlace and the Institut de la Finance Durable therefore applaud this regulatory initiative and its overarching objective. However, it appears to us that **the EC legislative proposal shows less ambition** as it could have been expected, notably based on the International Organisation of Securities Commissions (IOSCO) report on “ESG ratings and data products providers”³ and on the outcome of consultations involving providers, users and covered entities.

¹ See <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52023PC0314>

² “Questions and Answers on the Sustainable Finance package”, European Commission, 13 June 2023.

³ “Environmental, Social and Governance (ESG) Ratings and Data Products Providers”, Final Report, IOSCO, November 2021

To this extent, Paris Europlace and the Institut de la Finance Durable would like to raise the attention of co-legislators on certain areas of concerns where it is paramount to enhance the current regulation proposal. This is essential to ensure a sufficiently robust and ambitious regulation that is needed to properly address the growing role and influence of ESG ratings and data products providers in financial markets generally, and in the sustainable finance ecosystem more specifically.

1. ESG Data products providers should be in-scope of the regulation

Conversely to the IOSCO recommendations, that are targeting both ESG ratings and ESG data products, the EU regulation proposal focuses only on ESG ratings. They are defined as opinions (assessment by an analyst) or scores (systems or models) based on an established methodology and defined ranking systems. The absence of ESG data products in the regulation is therefore a major issue of concern.

Extending the scope of this legislative proposal to ESG data products, including raw data, is necessary. Indeed:

- ***ESG data products are key***

ESG data products are as crucial as ESG ratings to make informed investment decisions in the ESG space, both for a proper risk management and for better assessing the investments' impact on the whole society.

They are also critical to meet regulatory requirements, in particular regarding disclosures to end investors (under SFDR and MiFID 2 in particular).

- ***Reliability and transparency considerations should also apply to ESG data products***

Though they can be subject to some assessment or to a system/model for estimation, proxy, calculation, ESG "processed" raw data (in the absence of a reporting by the covered entity) differ from ESG ratings' definition due to the absence of a ranking system. This leads to a fragile frontier between ESG ratings and ESG "processed" data products resulting in potential circumventions, and depriving users of ESG data products from the benefit of the regulation proposal, notably transparency requirements (over the methodology used for estimate, proxy,...).

As far as ESG "reported" raw data (publicly or not) by a reporting entity are concerned, the absence of methodology shall not prevent the entity from complying with quality requirements for ESG data provider to collect, format and re-disseminate such data. Indeed, users often face with a lack of robust process and internal control over data products at providers, including discrepancies between the providers' raw metrics and those disclosed by the reporting covered entities. Most requirements of the regulatory proposal could well apply – notably by requiring data products providers to develop and use adequate and effective systems, resources, internal control mechanisms and procedures.

ESG processed and reported raw data are entangled: what is not reported is processed and/or estimated. Even if the Corporate Sustainability Reporting Directive (CSRD) and the European Single Access Point (ESAP) regulations will extend the scope and quality to "reported" raw data and facilitate its access, we note that:

- CSRD does not apply to a full range of undertakings (many non-EU, and EU SMEs that are not listed) or applies in a simplified mode (consolidated reportings of non-EU parents, listed SMEs).
- Due to the phase-in approach of CSRD, it will take time before a full implementation is in place (the last phase ends up in 2029 but sectorial data may be postponed further).
- ***Ensuring regulatory consistency and accountability of key players along to the whole sustainable investment value chain is essential***

Given the high volume of ESG data points, due diligences by asset managers or benchmark administrators over ESG data products providers, though necessary, cannot ensure that providers are taking all the necessary steps to achieve high-quality ESG data. This is exacerbated by a limited contractual leverage – even by large financial institutions – due to the oligopolistic situation in the ESG data market, data coverage considerations, and the complexity of the operational set-up (e.g. IT connectivity and integration in the users’ in-house systems cannot be changed easily).

This is typically a situation the regulatory sustainable finance framework is meant to address in order to ensure a proper protection of end investors. ESG data products providers must be considered as an essential link of the sustainable investment value chain (SIVC), from the issuer to the distributor of the financial product.

To this extent, the ESMA’s progress report on greenwashing⁴, dated 31 May 2023, states that greenwashing can spread across the SIVC, intentionally and unintentionally, and can be triggered by ESG rating and data providers (p. 6). More particularly, *“greenwashing can also arise from the overall poor transparency of methodologies regarding ESG data (e.g., assumptions and estimates used for providing ESG data points like GHG emissions) due to the use of external data providers, which is a cross-sectoral issue that is particularly relevant for benchmarks and funds”* (p.49). To this extent, *“ESG data providers should publicly disclose their methodologies, in line with the International Organisation of Securities Commissions (IOSCO) standards”* (p. 66).

Thus, creating a regulatory loophole in the value chain increases the risk of unintended consequences affecting end investors, such as (unintentional) greenwashing, as well as legal and reputational risks for market players in the downstream value chain.

- ***Extending the scope of the regulatory proposal to ESG data products is necessary***

Providers subject to the regulation should be limited to those who market ratings and data products on a commercial basis for a charge. Under this definition, 160 ESG ratings and data products providers (worldwide) have been identified in IOSCO’s report⁵. This limitation would allow to capture:

⁴ See https://www.esma.europa.eu/sites/default/files/2023-06/ESMA30-1668416927-2498_Progress_Report_ESMA_response_to_COM_RfI_on_greenwashing_risks.pdf

⁵ IOSCO’s *report on ESG ratings and data products providers*, November 2021, page 6 ; Referring to KPMG’s *Sustainable Investing: Fast-Forwarding Its Evolution*, February 2020, that mentions 150 ESG ratings and data products providers.

- A workable scope of providers for ESMA’s oversight (excluding de facto academics, journalists, etc...), but a large spectrum of data and users – both directly (subscribers) and indirectly (end investors).
- Profit and non-profit organisations as long as they market their services, through commercial or membership fees or dedicated private funding to get access to the ESG ratings/data.
- ESG data embedded in the ESG data products, and disseminated on a large scale, namely to financial institutions for elaborating ESG financial products.

2. Make sure the proposed regulation targets the appropriate market players

While this regulation should be extended to data products, it should not capture entities that do not market ESG ratings and data products as a service.

The regulation proposal uses different broad wordings: “providing”, “distributing”, “offering”, “publicly disclose”. In contrast with such an undefined scope, it is paramount that this regulation **targets only the providers who market ESG ratings and data products (for a charge), in line with IOSCO’s definition.**

In addition, under the current regulation proposal, the exclusions from the scope listed in the regulation could lead to misinterpretation. For instance, the proposed regulation rightly excludes ESG ratings produced by regulated financial undertakings for internal purposes and for providing “in-house” financial services and products. Indeed such undertakings are already subject to regulation, both at corporate level (governance, conflicts of interest,...) and at product/service level (SFDR, MiFID, UCITS,...). Nevertheless, the notion of “in-house” financial services and products can be misinterpreted. The exclusion criteria should be clarified to encompass ESG ratings produced by regulated financial undertakings and provided to entities of their group, or disclosed due to regulatory requirements or necessary to provide regulated financial services or products and inform on investment choices in this context.

3. Apply a solid level playing field framework and proportionate measures

While Paris-Europlace and the Institut de la Finance Durable recognizes the importance of preserving the access of non-EU providers to the European Union market and to foster competition, it is essential to make sure that competition remains fair and that a level playing field is preserved between third-countries and EU providers.

This notably implies :

- ***Third-country providers under endorsement or recognition marketing ratings (and data) in the EU are subject to the same requirements as EU providers***

Due to the lack of equivalent legislations in other jurisdictions, and given the predominance of providers headquartered outside the EU, the regulation proposal introduces the

endorsement and the recognition regimes within its scope-in third-country ESG rating providers.

However, it introduces the possibility that, under these regimes, a compliance with IOSCO recommendations is deemed equivalent to compliance with the requirements of the proposed regulation. Referring to such an equivalence raises significant concerns as IOSCO recommendations are unlikely to be as stringent as the requirements of this EU regulation. Consequently, this equivalence with IOSCO recommendations should be removed. Otherwise it could lead to level playing field issues, benefiting to third-country providers, and hindering the competitiveness and the emergence of EU market players.

- ***A threshold for recognition***

In order to make it sure that the recognition regime is fit for purpose and is not used by non-EU big players to circumvent the third-country regime, it is essential to limit it to small non-EU players. Therefore, Paris Europlace and the Institut de la Finance Durable welcome a threshold above which the recognition regime cannot apply and where the provider shall opt for the endorsement regime (with an affiliate endorsing entity in the EU) or for an implementation in the EU.

This threshold should however target the EU ESG data and rating business of the provider rather than its turnover. It should also be appreciated on a consolidated basis to avoid circumventions.

- ***Proportionate measures***

Paris Europlace and the Institut de la Finance Durable welcome the exemption regarding certain governance requirements granted to small and medium sized providers.

While, as already said, the future legislation should be sufficiently ambitious to capture and properly regulate the biggest players that have a strong market power in a context of an oligopolistic market, it is also crucial to preserve the ability for smaller players to enter the market as it may foster innovation and competitiveness.

Therefore, it is essential to ensure that the regulation encourages the emergence of small market players by relaxing some obligations which could prove disproportionate.

4. Enhance transparency

- ***The transparency on fees and commercial terms should be strengthened***

While the proposed regulation accurately emphasizes on fair, reasonable, transparent and non-discriminatory (“FRANDT”) treatment of users of ESG ratings, further enhancement are necessary to address effectively the current oligopolistic nature of the ESG ratings and data products market.

To ensure that providers effectively take adequate steps to apply the FRANDT principle, they should at minimum provide ESMA on a regular and systematic basis with their pricing grids

their pricing policy as well as their commercial terms and with any other evidence ESMA deems necessary. This would concur with the approach of the Credit Rating Regulation⁶. Furthermore, to avoid unbalanced contractual relations in the context of an oligopolistic market, the FRANDT principle should also be extended to encompass other commercial terms as well.

- ***Disclosures requirements for users can be improved***

The regulation proposal represents a significant step forward in promoting transparency within the ESG ratings activities, more particularly as regards methodologies, models, and key assumptions.

Paris Europlace and the Institut de la Finance Durable believe such requirements could be better aligned with users' need. For instance it could:

- Clarify explicitly the materiality principles (single or double) prevailing for the rating.
- Extend transparency on each E, S, G pillar, in addition to enhanced transparency on the ESG aggregation methodology.
- Clarify controversy scores (by degree of severity) on ratings and require detailed explanations on what constitutes a controversy and how severity scores are set.

5. Ensure a minimum dialogue with rated entities

Current practices are quite heterogeneous and can result in rated entities discovering ex post some misinterpretation or misunderstandings of their activities. To this extent, and without impairing the independence of the ESG rating providers, the latter should at minimum:

- Inform the rated entities of the schedule and steps, from the preparation of the final issuance.
- Provide in advance the rated entity with a draft report before issuance.
- Agree on a comment period, with a minimum of 10 working days to comment.

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To conclude, Paris Europlace and the Institut de la Finance Durable are very keen to engage with co-legislators in order to build an efficient European regulatory framework on ESG ratings and data products providers, fostering trust and confidence in the sustainable space. We are convinced that it is crucial that such a regulation adequately covers the sustainable investment value chain, provides well balanced obligations where both EU and non-EU providers marketing in the EU can be treated equally as much as possible and in a proportionate manner, to the final benefit of users and end investors.

⁶ Credit rating agency regulation 1060/2009 / ANNEX I - Section B – 3c / ANNEX I - Section E – II Periodic disclosures