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EU ESG: European Commission Proposes Regulation for ESG Ratings Providers

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TO: ICI Global Members
Europe Regulatory and Policy Committee SUBJECTS: ESG
International/Global RE: EU ESG: European Commission Proposes Regulation for ESG Ratings Providers

On June 13, 2023, the European Commission published a proposal for a regulation on ESG ratings providers ("Proposal")[1] as part of a new sustainable finance package.[2] The Proposal will now go through the ordinary legislative procedure whereby the European Parliament and Council will determine their positions on the text before it is negotiated among the Commission, Parliament, and Council.

The Proposal would introduce an authorization regime for ESG ratings providers operating in the EU, under which authorized providers would be subject to governance requirements to ensure the quality of ESG ratings. Providers would be required to disclose information about their underlying methodologies, and manage conflicts of interest. The European Securities and Markets Authority (ESMA) will be responsible for the authorization and supervision of ESG ratings providers.

The Proposal generally aligns with the recommendations of the International Organization of Securities Commissions (IOSCO),[3] however, in contrast to the IOSCO 2021 recommendations, the Proposal covers only ESG ratings and excludes raw ESG data (where elements of ratings or scoring are absent).

Notably, the Commission's Proposal does not introduce any classification for ESG ratings products, nor prescriptive criteria for ESG ratings methodologies with the intent to harmonize ratings. This is a shift from the policy objectives stated in the Commission's targeted consultation on the functioning of the market for ESG ratings in June 2022.[4] The primary concern expressed by the Commission at the consultation stage was the observed inconsistencies among ratings.

ICI Global submitted a response[5] to the Commission's targeted consultation highlighting the benefits that a diversity of views and independent methodologies brings to investors. We recommended that the Commission, as an important first step toward addressing transparency issues, convene industry experts to develop an industry code of conduct for ESG ratings and data providers based on the IOSCO 2021 recommendations.

Scope of ESG Ratings

The Proposal covers ESG ratings that are (i) disclosed publicly, or (ii) distributed to regulated financial undertakings (including asset managers), undertakings under the scope of the Accounting Directive (including public and private limited liability companies, certain unlimited companies and partnerships),[6] or public authorities in the EU. ESG ratings that are not intended for distribution or public disclosure are excluded from the scope of the Proposal. The Commission noted in the Explanatory Memorandum that the Proposal is intended to target ESG ratings provided commercially to other market participants.

The Proposal excludes raw ESG data, which do not contain an element of rating or scoring and are not subject to any modeling or analysis, ESG ratings produced for internal purposes or in-house financial services and products, and ESG ratings from an authorized provider that are made available to users through a third party.

Authorization Regime for ESG Ratings Providers

An ESG ratings provider will be required to obtain authorization from ESMA in order to provide ESG ratings in the EU. The Proposal delegates ESMA to develop detailed information required for applying for authorization in a draft regulatory technical standard. ESMA would be responsible for maintaining a public register on its website with all authorized ESG ratings providers. ESMA will charge supervisory fees to the ESG ratings providers that are proportionate to the providers' annual net turnover.

Transitional Arrangements. An ESG ratings provider who currently provides ESG ratings in the EU should notify ESMA within three months following the effective date of the proposed regulation ("Effective Date") if it intends to continue offering ESG ratings in the EU, and apply for authorization within six months after the Effective Date. If such a provider is categorized as "small and medium" under the Accounting Directive,[7] it will have 24 months after the Effective Date to apply for authorization. Small and medium ESG ratings providers entering the market after the Effective Date should notify ESMA before offering their services, and should apply for authorization within 12 months of that notification.

Equivalence, Endorsement or Recognition Regimes for Overseas Providers. Where an ESG ratings provider is based outside the EU, as long as it is authorized/registered and supervised in its home country, and the Commission has made an equivalence decision on its home country's regulatory framework for ESG ratings providers, such overseas ESG ratings provider will be allowed to provide ESG ratings in the EU. Before an equivalence decision is made, or when such a decision is repealed, overseas ESG ratings providers with an annual net turnover on their ESG ratings activities below EUR 12 million for three consecutive years may instead seek "recognition" from ESMA in order to provide ESG ratings in the EU. These recognized providers should appoint a legal representative located in the EU who will be accountable to ESMA.

Alternatively, an EU-based authorized ESG ratings provider could endorse the overseas provider within the same group, provided that the EU-based provider could demonstrate that its overseas counterpart is subject to requirements comparable to the proposed regulation. The EU-based provider should also provide objective reasons for (i) its overseas counterpart providing the ESG ratings in the EU and (ii) endorsing the ESG ratings for the use in the EU.

In cases of equivalence decision, endorsement, and recognition regime, the Commission will take into account whether the overseas regulatory framework for ESG ratings providers, or the overseas providers themselves, comply with the IOSCO 2021 recommendations.

Major Requirements for ESG Ratings Providers

Disclosures of Methodologies to Public, and Subscribers and Rated Entities. The Proposal would require ESG ratings providers to publish information on the methodologies, models, and key assumptions underlying their rating products on their websites, and provide more detailed disclosures to their subscribers and rated entities, for example, information about engagement with rated entities. ESMA will develop a regulatory technical standard specifying the details of disclosure items provided in the Proposal.[8]

In particular, the Commission expects the ESG ratings providers to disclose the materiality dimensions the ESG ratings are assessing – material financial risk to the rated entity, material impact of the rated entity on the environment and society, or both. ESG ratings providers should indicate if the analysis is backward- or forward-looking, and provide general information on criteria used for establishing their fees. When identifying topics covered by the ESG ratings within the E, S, or G factors, the ESG ratings providers should further specify whether these correspond to the topics in the European Sustainability Reporting Standards (ESRS).[9]

Management and Mitigation of Conflicts of Interest. Similar to the IOSCO 2021 recommendations, the Proposal would require ESG ratings providers to adopt and implement internal due diligence policies and procedures that ensure their business interests do not impair the independence or accuracy of the ESG ratings activities. ESG ratings Providers should review their operations at least annually to identify potential conflicts of interest.

In cases where a conflict of interest arisen from ownership structure, controlling interests, or other business activities of an ESG ratings provider and its affiliates is deemed not managed appropriately, ESMA could require the provider to cease the relevant activities or relationship, or halt the provision of the ESG ratings.

Separation of Businesses and Activities. The Proposal would prohibit ESG ratings providers from providing certain activities, which include issuance and sale of credit ratings, development of benchmarks, and investment activities. ESG ratings providers should ensure that their other business activities do not create conflicts of interest with the ESG ratings activities.

Fair and Transparency Fees Charged to Clients. The ESG ratings providers should ensure that the fees charged to clients are 'fair, reasonable, transparency, non-discriminatory and are based on costs." If otherwise, ESMA may require ESG ratings providers to provide documented evidence, take supervisory measures,[10] or impose fines.[11] The Proposal, however, does not further elaborate on the relevant requirements.

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Notes

[1] See Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, June 13, 2023, available at https://ec.europa.eu/finance/docs/law/230613-proposal-sustainable-finance_en.pdf; and Annexes available at https://ec.europa.eu/finance/docs/law/230613-proposal-sustainable-finance-annex_en.pdf.

[2] In addition to the proposed regulation on ESG ratings providers, the sustainable finance package also includes a set of new and amended Taxonomy Delegated Acts, recommendations on facilitating transition finance, and a communication on the usability of the sustainable finance framework. See COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS: A sustainable finance framework that works on the ground, June 13, 2023, available at https://ec.europa.eu/finance/docs/law/230613-communication-sustainable-finance_en.pdf.

[3] See FR09/21 Final Report Environmental, Social and Governance (ESG) Ratings and Data Products Providers, November 2021 ("IOSCO 2021 recommendations"), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf; ICI Memorandum [33922], dated November 24, 2021, available at https://www.ici.org/memo33922.

[4] See ICI Memorandum [34103], dated April 8, 2022, available at https://www.ici.org/memo34103. Also See Targeted consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings (April 2022), available at https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2022-esg-ratings_en.

[5] See ICI Memorandum [34175], dated June 6, 2022, available at https://www.ici.org/memo34175.

[6] See Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance ("Accounting Directive"), available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0034.

[7] See Accounting Directive, supra note 6, at Article 3.

[8] See Annex III, supra note 1.

[9] Companies under the scope of the Corporate Sustainability Reporting Directive (CSRD) will be required to report sustainability information in accordance with the ESRS. The Commission launched a consultation on the draft Delegated Act for the first set (sector-agnostic) ESRS on June 9, 2023. See European sustainability reporting standards - first set, available at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en.

[10] Supervisory measures, among others, include (i) withdrawing the authorization of the ESG ratings provider, (ii) temporarily prohibiting the ESG ratings provider from providing ESG ratings, and (iii) suspending the use of ESG ratings provided by the ESG provider. See Proposal, supra note 1, at Article 33(1).

[11] The maximum amount of the fine would be 10% of the total annual net turnover of the ESG ratings provider. See Proposal, supra note 1, at Article 34.