FESE

FESE position paper on the Proposal for a Regulation on the transparency and integrity of ESG rating activities

Brussels, 2nd October 2023

Introduction

FESE welcomes the Commission's proposal for a Regulation on the transparency and integrity of ESG rating activities. We believe that the proposal is balanced and represents a good starting point, and that it could contribute greatly to the sustainable transition and sustainability objectives in line with the European Green Deal and UN Sustainable Development Goals.

The continued growth of ESG ratings reflects the growth of the sustainable investing market as a whole and the success of sustainable finance in the EU. Investors and issuers are seeking authoritative and independent sources of ESG performance assessment and benchmarking, which is key for investment decisions. Moreover, the emergence of an increased volume of publicly disclosed company sustainability data in the coming years, resulting from both mandatory corporate sustainability reporting and continued voluntary reporting, will continue to drive appetite for ESG research and analysis.

In this context, ESG rating providers play an important role for the overall sustainable investment ecosystem and should ensure that they contribute to the sustainable transition with proper governance arrangements, reliable methodologies, independent advice, scientific expertise and market knowledge. Any new regulatory intervention in this field needs to strike a good balance between the overarching policy objectives of the EU and crucial market development, including innovation in the ESG rating industry.

FESE supports the overall activity-based scope covering only ESG ratings factoring in IOSCO definitions and recommendations. We also appreciate the establishment of principles-based organisational requirements and recognise that transparency and disclosure requirements are key aspects. Methodological transparency can contribute significantly to the application of relevant metrics to achieve the objective of the investment product and thus maintain investor trust.

In general, it is important that the regulation is proportionate and does not result in a too burdensome and costly regime impacting innovation and coverage of smaller issuers. Bearing in mind the Commission's goals to grow SMEs and allow them to fully benefit from the opportunities that European capital markets can bring, we believe that it is essential to ensure that SMEs continue to be tracked and rated.

While the general direction of the proposal is promising, we consider that some aspects could be refined. Below, we take the opportunity to elaborate further on FESE's considerations on the Commission's proposal.

1. Scope

FESE supports an activity-based regulation encompassing ESG rating providers while excluding raw data from the scope. We also see value in the Commission leveraging the IOSCO definition of ESG ratings to contribute to a more cohesive and coherent regulatory

landscape in the ESG rating space. However, the lines are blurred and further refinement is needed. We believe that clear definitions are central to the workability of the regulation, and ultimately its effectiveness.

The definition of an ESG rating in the proposal appears to be the loosest interpretation of the 'data' versus 'rating' boundary of any jurisdiction, which could contradict the Commission's proposal in other places. The EU definition seemingly captures anything other than 'raw' reported data, with only minimal exclusions under Article 2, but is overly broad to cover pure calculations and estimates though it appears the Commission's intent to exclude such products under Article 2(c)[1]. The proposed breadth of this definition, and thus regulatory requirements, risks disincentivising providers from offering their full range of services to EU clients, potentially reducing the availability of ESG data within the Union. As with the EU Benchmarks Regulation (BMR), where the originally proposed scope was also too expansive and ultimately narrowed, we would suggest further consideration to define the scope of the ESG Rating definition in the proposal to be internally consistent within the proposal and provide clarity to the market.

FESE notes that the Commission decided to distinguish between ESG rating providers and second-party opinion providers (SPOs) by excluding the latter. Considering that the EU Green Bond Standard also creates a regime for the registration and supervision of external reviewers, we would like to stress the importance of overall coherence in order to not make the sustainable finance regulatory landscape overly complex. In addition, we would also like more clarity on the term 'raw ESG data' to better understand what exactly is excluded from the scope of the proposal.

2. Conflicts of interest

While recognising that the ESG research and data analytics business is not uniquely prone to potential conflicts of interest, including in comparison to the entire financial research and analysis industry, FESE considers that conflict of interest provisions should be in place and that all perceived or actual conflicts of interest and steps taken to address them should be publicly disclosed.

FESE believes that there are a multitude of players in the market providing ESG ratings making the space competitive. In this context, introducing price regulation is a severe market intervention which must be avoided or sufficiently motivated by proof of market failure. In this regard, the Commission's impact assessment is not sufficient as it fails to demonstrate that existing fee structures impair the fair and orderly functioning of markets, and that regulatory intervention in the pricing of ESG ratings is a targeted, efficient and proportionate policy measure to take. Generally, commercial fees and structures should be left to the market and not driven by public authorities. Depending on its interpretation, we see the "based on cost" requirement as extremely critical as it would mean that there is no real incentive for providers to perform ESG ratings, which could negatively impact the EU's Green Deal agenda. Such an approach could also be precedent-setting and have a chilling effect on the growth of the market, including importantly new market entrants.

In general, we would call for a better impact assessment on why intervention in pricing is considered necessary, including the competencies of ESMA in that regard.

[1] Article 2(c) proposes that the Regulation does not apply to "the provision of raw ESG data that do not contain an element of rating or scoring, and is not subject to any modelling or analysis resulting in the development of an ESG rating".

3. Governance and transparency requirements

3.1. Organisational requirements

FESE welcomes the Commission's proposal to establish principle-based organisational requirements. This comprehensive coverage of principles would help organisations strengthen their internal processes while safeguarding the necessary independence of providers and avoiding conflicts of interest. The introduction of very strict requirements could hinder the development of this growing industry and limit the diversity of research offerings available in the market.

3.2. Transparency requirements

FESE also supports the Commission's approach to foster methodological transparency without pursuing methodological harmonisation. The independence of choice of ESG rating providers should be maintained. The transparency provisions have the potential to positively impact the accuracy, and comparability of ratings, which will prove beneficial for users of ESG ratings as well as for corporates subject to ESG ratings. This will provide investors with greater confidence in the integrity and objectivity of ratings and empower them to make well-informed decisions. Rated entities, in parallel, will better understand their rating results and be able to use them to internally steer their business.

The variety of ESG ratings is a natural and positive feature of the market; it is the result of investor demand for a multitude of analytical options to help them understand and manage investment risks and opportunities, as well as to implement their own, potentially varied investment thesis or help with their own regulatory reporting. Therefore, FESE supports that while introducing proper disclosures, the Commission is aiming at preserving methodological freedom by not setting minimum requirements on the content of ESG ratings, and recognises that disclosure of information concerning rating models should not reveal sensitive business information or impede innovation. For these reasons, we are also supportive of the non-interference clause. Furthermore, it would be important that intellectual property rights are protected.

4. Authorisation and supervision regime

4.1. Authorisation

As regards the provision of ESG ratings in the EU, we see scope for further refinement in the third-country regime foreseen in the proposal. Given that currently, most larger ESG rating providers are non-EU companies, it would make sense to align an authorisation and registration system with third-country provisions in other pieces of regulation, although many of these are currently under discussion, such as the BMR. While FESE fully supports that compliance with IOSCO recommendations for ESG Ratings is deemed equivalent to the proposed regulation, it should be noted that equivalence does not currently exist in any jurisdiction. Overall, the proposed third-country regime is more restrictive compared to the BMR, which could lead to consequences such as inaccessibility to some ratings and limited availability and variety of ESG ratings and the underlying research. By contrast, we believe that allowing access to the EU market for third-country providers will ensure a wider range of ESG ratings already being used by EU investors, which are subject to transparency as to their underlying methodology.

FESE supports a level playing field between EU and third-country players in terms of regulatory requirements. The Commission states that the proposal is "*origin neutral as it*

would apply equally to domestic and third country operators"[1]. However, the requirements for third-country recognition appear to be more burdensome than those for authorisation for EU-based providers. The proposed recognition requirements include all authorisation requirements as well as an independent external audit or certification, legal representation within the EU, and a cooperation arrangement between ESMA and the third-country supervisor. Moreover, recognition seems limited to providers with an annual net turnover of their ESG rating activities below EUR 12 million for 3 consecutive years, and it is unclear what steps a third-country provider should take once this recognition threshold is exceeded. Moreover, the threshold effectively places a limit on the revenue that a third-country provider can generate unless it wants to lose EU market access. This may serve as an artificial break for third-country ESG rating providers to serve EU clients with respective services and may restrict the breadth and depth of ESG ratings accessible to EU clients. In this regard, we believe the proposal is disproportionately restrictive relative to ESG rating providers when compared to similar authorisation options under other regulations, and we would support an approach historically consistent with established practices.

4.2. Supervision

According to Article 34, the proposed fines for infringement of the Regulation can reach up to 10% of the provider's total annual net turnover. This amount is not proportionate and fails to distinguish between intent and negligence. Furthermore, since the provisions refer to groups of companies falling under the EU Accounting Directive, it can be interpreted that fines are based on the net turnover over the ultimate parent company.

5. A proportionate regime for SMEs

FESE also appreciates the introduction of provisions aimed at mitigating costs and impacts for SMEs, such as the possible exemptions on governance requirements, proportionality of the supervisory fees and the introduction of a transitional period for authorisation.

Whilst today the market consists primarily of sophisticated large non-EU players that are specialised in a wide range of diverse and various ESG-related activities, we have witnessed the emergence of smaller EU-based companies that focus on certain ESG niche markets. These smaller niche providers have proven to add substantial value, with high-quality output. Therefore, it will be relevant to maintain an environment which incentivises the entry of small and medium-sized providers into the market, as well as their development and innovation. For these reasons, we also believe the regulation should be principles-based, so as to not incentivise users to rely on the services of larger providers if they are perceived to meet more strenuous or costly regulatory obligations than smaller providers. Such a discrepancy would be at the expense of encouraging new market entrants.

6. Others

6.1. ESAP

We wish to caution against the escalating volume of required disclosures to the ESAP when even the tool has not yet been implemented. The extensive amount of information demanded from providers in a machine-readable format before ESAP's expected launch in the summer of 2027 poses significant challenges.

[1] Impact Assessment Report, p.52