

SEPTEMBER 2023

AFG'S ANSWER TO

EU Commission's proposal for a regulation of ESG rating activities



AFG



The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 700 management companies, with €4600 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

EU COMMISSION'S PROPOSAL FOR A REGULATION OF ESG RATING ACTIVITIES

We welcome the proposal by the European Commission for a regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities. The planned introduction of regulatory standards for ESG rating agencies and their rating activities appears suitable in a context where increased ESG integration in investment activities, including on regulatory basis, emphasises the need for quality and traceability of ESG data and ratings.

This initiative should aim to improve their transparency, address existing shortcomings in the ESG rating market, and positively impact the functioning of financial markets and the conditions for ESG investing. We support in particular:

- The introduction of detailed disclosure requirements on ESG ratings, including their objectives, traceability and quality of underlying data, methodologies used, and updates frequency, which should improve the reliability, comparability of and trust in ESG ratings.
- The disclosure of whether the rating addresses double or simple materiality (recital 21).
- The proposal's robust organizational requirements to, among others, manage risks of conflict of interests and very importantly, require sufficient control set-up to ensure the integrity and the reliability of the rating.
- The proposal for fair, reasonable, transparent, and cost-based fees and that ESMA will act in case of violations. Nevertheless
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- , we would like to extend FRANDT measures to commercial terms.
- A harmonized authorization and supervision regime by ESMA for providers to be able to offer ratings to EU based companies.

However, to ensure the success of this initiative, we believe it is necessary to broaden the scope, better align third country providers and clarify important issues:

I. Scope

- 1. Inclusion of Issuers' or other public sources' ESG raw data gathered and disseminated by commercial providers as well as ESG data products built by such providers (both being defined as hereafter "ESG Data products), in the scope of the regulation, as being part of 'ESG Data Products' in line with IOSCO Recommendations 1**

ESG data products are as important as ESG ratings in investment decisions and in regulatory reporting requirements. Both should be supported by high quality data. This is key for the AFG' members: through their user experience, data products (even on raw data reported by an investee company and transmitted by the data provider) are lacking sufficient quality controls at the providers', which puts the liability on users when used afterwards. The latter have little leeway to put pressure on the providers to get better quality given the extreme dependency upon the providers which cannot be changed easily (due to connectivity challenges, data coverage...). **This capture of marketed ESG Data**

¹chrome-extension://efaidnbmnnnibpcajpcgiclfndmkaj/https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

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Products and ESG Ratings by providers is critical, to ensure that the whole ESG Value Chain is supervised – in order to reduce significantly the risk of unintended Greenwashing by asset managers or owners, when taking their investment decisions on ESG Data marketed by third parties and which might appear afterwards as wrong. We are therefore strongly asking for their integration in the regulation with a reflection in the whole proposal.

In addition, to avoid any confusion and ambiguity in the scope of application, and in line with IOSCO's Recommendations, the regulation should only cover ESG data products and ESG ratings which are **marketed (this term should be defined in the content of the proposal). This is a crucial parameter in setting the scope, to differentiate with data or ratings which are only used internally or are not sold to any type of client, versus those which are sold as such by providers.**

Lastly, unlike financial data, ESG data are not yet subject to international reporting and audit standards. Though there are initiatives in this respect, it will take some time to reach a broad scope in terms of reporting entities, common definitions, and data points at global level. **This leads to the use of proxies and estimates, and therefore stresses the need for transparency in methodology, as well as compulsory checks, not only on ESG ratings but also on ESG data products.**

Reliable and comparable ESG data products is a prerequisite for the proper functioning of the European sustainable finance market in a similar way as ESG ratings. There is a high demand for reliable and comparable ESG data, due to regulatory reporting requirements for financial market participants under SFDR and EU-Taxonomy, but also for proper implementation of sustainable investment strategies and management of sustainability risks. For many investors and providers of financial products ESG data play an even more important role than ESG ratings. The current lack of transparency and reliability of ESG data not only weakens users' confidence in the accuracy of the data but increases their risk of being subject to greenwashing allegations. **Better comparability and higher reliability, as envisaged for ESG ratings, is therefore also needed for other ESG data products than ESG ratings.**

2. Clarification for ESG ratings produced by regulated financial undertakings (Recital 15, article 2(2)(b))

We welcome the exclusion of “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 (i.e. SFDR, EU Taxonomy,).

However, the article 2(2)(b) raises some questions with regards to the disclosure of some regulatory elements that may be also captured by the ESG ratings regulation. Indeed, under the SFDR, for instance, financial market participants need to publish in their precontractual, periodic and website some information on financial products and notably the sustainable investment percentage. This sustainable investment percentage is based on each financial market participant methodology, is not provided for internal purpose (as it is published on financial products documentation including ex ante) and could then fall under the ESG rating regulation.

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Yet, the SFDR provides with several supervisory requirements. In this context, **we believe that article 2(2)(b) should be clarified to exclude from the scope of the regulation any rating that could be provided by financial market participants as they are already covered by other pieces of regulation.**

Finally, we believe that **the use of proprietary ESG ratings should be extended to also capture intra-group exchanges of such ratings, included in the accounting consolidated group or to the assets under management of the group.**

3. The definitions of the proposed Article 3 should be clarified:

- **The definition of ESG rating remains unclear.** See Article 3: *'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'. The frontier of such definition with some data can be unclear as for temperatures? Controversy scores (including severity)? Etc... this leads to possible circumvention.
- **Linked to our point 1, the scope of the regulation should cover ESG data, and therefore introduce a definition of ESG data products.**

To this end, we believe that the definition should be strictly based on the IOSCO one, as contained in the IOSCO Recommendations, and completed as follow:

"ESG data products": refer to the broad spectrum of gathered and re-disseminated raw data, as well as data products (including estimates, proxies and sectoral data), that are marketed as providing either a specific E, S, or G focus or a holistic ESG focus on an entity, financial instrument, product or company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment, whether or not they are explicitly labelled as "ESG data products".

II. Third country providers (under endorsement or recognition): level playing field issues.

The regulation proposal introduces the endorsement and the recognition regimes for providers who operate in the EU but are not domiciled in the EU. It gives the possibility that compliance with IOSCO recommendations is equivalent to compliance with the requirements of this regulation **for endorsement** (art. 10(1) – "ESMA may consider...") or **for recognition** (art 11(2) despite a wording that is unclear, and with an independent assessment). However:

- (i) IOSCO recommendations are unlikely to be "as stringent as the requirements of this regulation" and may not reflect some characteristics that the EU would want to push forward. Typically, IOSCO will not insist on detailing whether the rating is considering double materiality; And most

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importantly IOSCO's requirements are not as granular as this proposed regulation (and possible RTS detailing ANNEXES). **Therefore ESMA "may take into account" whether the endorsed or recognized entity is already applying IOSCO recommendations, but it shall not consider it is fully equivalent. The assessment by ESMA should only be based on compliance with the EU rules themselves.**

- (ii) **Most importantly, this raises level playing field issues. EU firms would have to comply with the EU regulation while non-EU firms that are endorsed or recognized would have to comply to IOSCO recommendations (which are more flexible) only! This would not foster the emergence of EU market players (i.e., domiciled and operating in the EU) in a market where major players are actually non-EU.**
- (iii) It should also be made clear that **the threshold for recognition should be assessed on an aggregated basis to avoid circumvention within a group** encompassing more than one recognized entity and/or by outsourcing to other entities of that group.

In any case, regarding non-EU ESG data and non-EU ESG rating providers considered as "critical" (to be defined in level 2), the third-country regime introduced in DORA should apply to complete the endorsement regime.

III. Annual external audits leading to external certifications.

This is critical to set a higher degree of safety regarding the final quality of marketed ESG data products and ratings.

For this purpose, the article 14(10) should be completed as follow:

"In addition, ESG data product and rating providers shall be subject to annual external audits, ensuring the external oversight of all aspects of the provision of their ESG ratings and data products, including the certification on processes and methodologies".

IV. Transparency requirement on fees

As already indicated above, we welcome the EC proposal for fair, reasonable, transparent, and cost-based fees (even if we consider that these requirements should be extended to commercial terms as well). However, we believe that the proposal remains very general and should be further clarified.

Indeed, currently, some major providers are not transparent on their fee grids – while conversely other providers are.

The Article 25(1) should be amended to read as follows: *"Such a transparency requirement shall also apply on their fee grids applicable to the users to which they market their ESG data product or rating services."*

In addition, Article 25 (2) should read *"ESMA shall"* instead of *"ESMA may"*. We believe ESG rating and data providers shall report annually to ESMA similarly to the requirements in the CRA regulation (1060/2009 - art 11.3 and ANNEX I - Section E – II.2)

V. Contractual provisions between providers and users:

The contractual relations between the Providers and the Users should be set, based on DORA Regulation, as the issue is very similar between ICT service providers and ESG Data Products as well

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as ESG Ratings Providers, in term of unbalanced contractual relations – which have then to be protected in this regulation.

An article 25a should be inserted in the proposal based on DORA Article 30.

VI. Include the entire group of the ESG rating provider in the regulation

In order to discourage anti-competitive behaviour and to avoid circumvention situations such as those observed today in the credit rating industry, it is crucial to ensure that the regulation on ESG rating activities does not provide any loopholes. Therefore, it will be particularly important **to include the whole group** of the ESG rating agency or ESG data provider - **including all subsidiaries** - in the regulation and to ensure that there are no circumvention possibilities in the involvement of third parties, **in particular in the dissemination of ESG ratings and ESG data via licensing agreements with unregulated group companies**. In order to avoid major distortions of the existing business models, the group-wide application should not apply to the separation of activities under Article 15.

The Regulation must e. g. ensure that the requirements for ESG ratings, such as the disclosures according to Annex III No. 2, are also met in these cases and that the pricing requirements under to Art. 25 are complied with.

VII. Disclosure requirements

We welcome the suggested proposals to increase transparency of the rating methodologies and data sources used, including disclosure of any limitations or use of estimates. **Of course, in line with our comment in I-1 above, disclosures on data shall not be limited to the sole data used in the ratings. It shall relate to all the data products.**

The now envisaged comprehensive disclosure requirements will contribute to increase transparency, enhance comparability and competition in the market and would thus be an effective approach to address existing challenges in this context both from a user and rated company perspective.

Regarding the addressee of the information to be disclosed according to Annex III No. 2, it is important to note that this information is not only received by the rated entity or subscribers, but more importantly also reaches the users of the ratings, e. g. institutional investors or financial institutions.

The disclosure obligations must apply in full, regardless of whether the user receives the rating directly from the ESG rating agency, an affiliated company or a third party. In order to avoid misunderstandings, we suggest clarifying Art. 22 accordingly by replacing the word “*subscriber*” with the word “*user*”.

In addition, we would recommend adding a transparency requirement on the underlying data used for a specific marketed ESG rating within the “Additional disclosures to users of ESG rating and rated undertakings in scope of Directive 2013/34/EU” (point 2 of Annex III). Indeed, it is not uncommon that users have restricted access to underlying data when purchasing ESG ratings (in some cases,

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commercialized separately), which significantly limits their ability to make an informed use. Furthermore, we believe transparency around data quality should be further detailed.

VIII. Requests of information

According to Art. 30, ESMA is authorized to obtain the information necessary for the exercise of its supervision not only from ESG rating providers but also from third parties. Since according to Art. 30 (2) e) there shall be no obligation to provide the requested information, we see a potential risk of circumvention or business misconduct. **It is important that the ESG rating agency remains responsible for the requested information in any case and that there is an obligation to provide information for the group companies involved.**

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