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ISDA RESPONSE TO THE MAS CONSULTATION ON THE PROPOSED CODE OF CONDUCT FOR ESG RATINGS AND DATA PRODUCT PROVIDERS

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The below responses were submitted to the Monetary Authority of Singapore online system on 22 August 2023.

ISDA response to the Monetary Authority of Singapore's consultation on the Proposed Code of Conduct for Environmental, Social and Governance ("ESG") Rating and Data Product Providers

I wish to keep my identity and responses confidential for the entire submission.	NO
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Question 1. MAS seeks views on the proposed definitions of "ESG rating" and "ESG data product", as well as the list of excluded products.

The International Swaps and Derivatives Association (**ISDA**) welcomes the opportunity to respond to the Monetary Authority of Singapore (**MAS**)'s consultation on a Proposed Voluntary Code of Conduct for ESG Ratings and Data Product Providers (**CoC**).

Scope

ISDA agrees with MAS' proposal to define ESG ratings and data products broadly, and in line with how these are defined in the IOSCO Report and the established codes of conduct for other jurisdictions, such as Japan or the UK's respective Codes of Conduct. In the meantime, we would suggest that the MAS continues to take account of the evolution in ESG rating and data products, as and when a regulatory framework is introduced.

We also welcome MAS's proposal to adopt a phased and proportionate regulatory approach, adopting a voluntary code as an initial stage with consultation on further regulatory to follow once there is greater regulatory convergence globally.

We recognise that this is a voluntary Code of Conduct and is therefore open to entities to decide for themselves whether or not to implement it and adhere to its Principles. However, having the Code available as a common standard for current best practice will help foster high standards and transparency while allowing for enough of the necessary flexibility needed for such a diverse market. It is critical that the appropriate steps are taken to reduce the risk of unintended greenwashing by both ESG ratings and data providers.

We also welcome the global work underway to improve sustainability disclosures, which should improve the availability and quality of ESG data. This should in turn enhance the reliability of ESG ratings.

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Exclusions

We recognise that this is a voluntary code. However, we believe it is important to maximise global interoperability and ensure sufficient clarity of in-scope activities and exclusions to support innovation and enhance workability. As such, we agree that the following entities and products should be identified as excluded from its scope:

- Credit rating and research analyses for any investment product. These activities are already heavily regulated under the Securities and Futures Act 2001 (SFA) and the Financial Advisers Act 2001 respectively, and adding further regulatory requirements may lead to duplication or even conflicting requirements.
- Financial benchmarks administrators - while financial benchmarks have been excluded from the definition of ESG data products, we recommend that this exclusion also be added to the definition of ESG rating products.
- Raw data or aggregated raw data which does not entail added estimations, calculations, or analysis.

In addition, we recommend that the following should also be excluded:

- Entities who do not provide or market ESG ratings/scores or ESG data products to third parties (e.g., entities that only produce ratings / scores / products that are used or consumed only within the same corporate group of affiliated companies for internal purposes or provide in-house financial services and products) should be excluded from the CoC.
- Entities whose commercial activities involve ESG consulting services, but that do not involve the provision of any ESG rating/score or ESG data product;
- Proxy advisers; Some other items where the risk of harm is low. For example the current definition could capture metrics that are derived from ESG ratings (e.g. proprietary derived ratings or scores).
- Financial products which are screened for ESG characteristics (whether this is a fund or another product offering, such as eligible collateral)

Question 2. MAS seeks views on whether external reviews such as Second Party Opinions should be scoped in as ESG data products under the CoC.

ISDA recommends that the Code applied proportionately to second party opinions. If these opinions are limited to assessing a particular product against existing standards, many of the governance and transparency measures proposed in the Code may be disproportionate although measures to manage and disclose potential conflicts of interest would be appropriate. This recommendation also aligns with our response to question 8.

Furthermore, applying the Code to second party opinions provided in the context of sustainability-linked bonds, loans and derivatives could assuage greenwashing concerns related to their use.

Question 3. MAS seeks views on the proposed definitions of "ESG Rating Provider", and "ESG Data Product Provider".

It is our understanding, and it would be helpful if MAS could explicitly clarify, that the activity of "offering" or "providing" ESG ratings relates to the production of such ratings and does not capture the distribution or placement of a third party produced ESG rating by a financial services intermediary (for example where embedded within a bond or other financial instrument). Defining the activity as "producing ESG ratings" would further clarify this.

Although the exclusions for the definition of 'ESG Data Provider' have helped alleviate some confusion, we also recommend defining the activity as "producing ESG data" to provide greater clarity.

In addition, in accordance with IOSCO's recommendations, entities should fall under the CoC as "ESG Rating Provider" or "ESG Data Provider" only when their ESG products are "marketed" to third parties. For instance, we noted one variation between MAS's definition and IOSCO's definition is IOSCO is setting that criterion of "marketed" ESG Data or Rating delivery as a key parameter:

The IOSCO definition of ESG rating products refers to: "*ratings products that are **marketed** 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.*"

The IOSCO definition of ESG data products refers to: "*the broad spectrum of data products 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"."*

As mentioned by MAS, a more detailed local regulatory regime will be developed when there is greater global regulatory convergence. ISDA members support the use of IOSCO recommendations as the basis for developing the local regulatory regime in the future.

It is noteworthy that MAS has defined the ESG Rating or Data Product Provider as entities who provide the products in relation to activities and institutions in the securities and derivatives industry. As an association that sets best practices for the derivatives market, ISDA members welcome the practice of including derivatives into the definition, as derivatives can play a crucial role in sustainable finance. They can enable more capital to be channelled towards sustainable investments; help market participants hedge risk related to environmental, social and governance (ESG) factors; facilitate transparency, price discovery and market efficiency; and contribute to long-term sustainable investments.

Question 4: MAS seeks views on the proposed best practices on ESG rating and data product providers' disclosure of how transition risks and opportunities are factored into ESG ratings and data products.

ISDA members fully support the proposed best practices on disclosure of how transition risks and opportunities are factored in. ISDA members believe that users value forward-looking metrics and strategic considerations on rated companies' transition towards a sustainable business above backward-looking information. Users would also benefit from increased transparency on whether the data is backward looking or forward looking.

ISDA generally advocates for enhanced transparency in methodologies, which can enable users to make more informed decisions on capital allocation. ISDA members agree that providers should disclose the measurement objectives of the ESG rating or data product because users need and value the clarity and transparency on what ESG ratings are measuring – whether it is ESG risk exposure, governance practices, level of disclosure, physical or transition risks, etc. The proposed disclosure measures would also help market participants to develop a clear view of the company's business, material sustainability impacts, and transition or adaptation plans.

We welcome the enhanced CoC to improve sustainability disclosures, which should improve the availability and quality of ESG data. This should in turn enhance the reliability of ESG ratings.

Question 5: MAS seeks views on the principles and best practices set out in the draft CoC in Annex 1.

ISDA members agreed that the timeliness, accuracy, and reliability of ESG ratings is essential for a fair and effective market, especially when ratings are employed to help meeting regulatory requirements or for the provision of loans - and thus have an impact on the cost for companies to raise capital. In addition to timeliness, the frequency of updates is a highly important factor.

Some other suggestions:

- Users would value a more granular categorisation of companies into different sectors. Ratings often cluster companies into broad sectors without providing granular analysis. The incorrect sector classification affects the comparison between companies because the material factors used to assess the rating may be different depending on the sectors.
- The ESG rating providers should provide a rating report explaining the final score or aggregated score provides invaluable contextual information for users to understand the purpose of each rating and identify the most relevant information and the most appropriate use for each rating.
- Treatment of controversies and how they affect the final rating is usually not transparent enough. ISDA members strongly consider that the collection and assessment of ESG controversies should be considered by MAS. Controversy reports and alerts are typically produced by ESG data and ratings providers for two purposes i) as a standalone controversy report or alert which may be used by investors as an additional screening mechanism, or by proxy advisors when producing recommendation reports; and ii) as a data point considered part of an ESG rating or scoring process. To restore trust and promote confidence in the ESG rating and data space, both purposes should fall within the Code.
- We refer to Annex 1 PREAMBLE, "market participants who use the ESG ratings and/or ESG data products are encouraged to engage providers who adopt the Code". Our members agree that products users be encouraged to engage Providers who adopt the CoC, but also have the flexibility to engage Providers who do not adopt the CoC to ensure adequate choice and allow for market innovation
- We would suggest that 'relevant personnel' are 'professional, competent, suitably qualified and persons of integrity'
- We recommend providing clearer distinctions in defining how its Principles apply to ESG rating providers rather than data providers (or vice versa), as outlined in question 9.

Question 6: MAS seeks views for the CoC to be adhered to on a "Comply or Explain" basis.

In light of further developments in the regulatory framework including bringing ESG rating providers into the CMS licensing regime under the SFA, a phased approach which starts with a "Comply or Explain" basis is appropriate. However, in the case where an entity is using a third party Provider which sufficiently explains why it isn't compliant with the CoC, we suggest the entity should not be expected to mandatorily explain why the third party Provider has been used and/or why it does not comply with the CoC.

Question 7. MAS seeks views on the proposed Checklist (Annex 2), whether it would enable product users to easily identify compliant providers and facilitate interoperability for ESG rating and data product providers' global operations.

ISDA members have reservations about whether the provision of a standalone Checklist would effectively ease the identification of compliant providers. For example, if a provider were to give "No" responses to certain questions in the proposed Checklist in Annex 2, but not all, would the MAS consider the provider "compliant" with the CoC?

Given that Providers are encouraged but not required to publish the Checklist on their websites, we would suggest that the MAS consider maintaining a publicly available database of "compliant" Providers for ease of reference of market participants.

Question 8. MAS seeks views on third-party assurance or audit on ESG rating and data product providers' self-attestations to be adopted on a voluntary basis.

ISDA agrees with MAS' proposal for third party assurance or audit to be adopted on a voluntary basis. We believe that requiring mandatory auditing would be premature at this stage as entities will need time to familiarise and adopt the CoC.

In the context of Sustainability-Linked Derivatives (SLDs), having an independent third party minimizes the risk of moral hazard and the potential for conflicts of interest to arise given the economic consequences of meeting or failing to meet sustainability KPIs. It may also minimize potential disputes. The involvement of a third party will be intrinsic where the KPI is linked to a counterparty's general ESG rating. This is because the counterparty will be deemed to have met the KPI if it is granted a specific rating by the ESG rating agency. In other cases, the third party will need to be specifically chosen and appointed by the counterparties. This third party may be (without limitation) an auditor, environmental consultant or expert in the particular subject matter of the KPI.

Question 9. MAS seeks views on any other suggestions to encourage ESG rating and data product providers' adoption of the CoC.

ISDA members consider that the CoC could be clearer in defining how its Principles apply to ratings product providers rather than data product providers (or vice versa). For example, it may be useful to include a table indicating where a Principle applies to a ratings product provider but not a data product provider, or if a Principle applies differently to the two types of product providers, flagging the key differences.

Question 10. MAS seeks views on the proposal to bring ESG rating providers into the CMS licensing regime under the SFA when a regulatory framework is developed.

We are supportive of the proposal to bring ESG rating providers, particularly those which are based in Singapore, under the CMS licensing regime under the SFA when a regulatory framework is developed. This should ensure accountability, quality and credibility of ESG ratings provided by licensed providers.

Question 11. MAS seeks views on whether overseas based ESG rating providers who offer ESG ratings to users in Singapore should be subject to the proposed regulatory regime for ESG rating providers, and the scope of activities of such providers to be subject to regulatory requirements.

MAS should consider the introduction of substituted compliance/equivalence provisions based on third country providers complying with the IOSCO recommendations. This is important to minimise duplication and potential conflicting requirements.

However, based on ISDA members' experience of such provisions in other legislative regimes, we would recommend that any assessment of substituted compliance or equivalence should be based on representations from the third country provider regarding their compliance with the IOSCO recommendations rather than being based on an assessment carried out by their home state supervisory / regulatory competent authority (as these activities may not be regulated in their home state) or on an assessment by MAS of alignment with IOSCO recommendations (either at the level of the relevant overseas regime or at the level of the relevant provider).

Question 12. MAS seeks views on the appropriate monitoring period (in months) and observable market milestones before consulting on a more formalized regulatory regime for ESG rating providers.

ISDA agrees with MAS's comments that the regulatory landscape is still evolving and that it will be necessary to monitor global regulatory developments and coordination before conducting a more detailed public consultation.

After discussion, ISDA members have reached a consensus that at least 12~18 months of monitoring period, with a preference for the longer end, should be provided before consulting on a more formalized regulatory regime for ESG rating providers. This would also allow MAS to have a sufficient timeframe to see an update of the voluntary Code by the industry.

Other Comments (Optional)

ESG ratings and data products perform an increasingly important role in capital markets and sustainable finance. We support the use of the IOSCO recommendations to ensure the code is internationally interoperable, noting that the UK, the EU, Japan, Hong Kong, and India have since developed (or are developing) Codes of Conduct and/or regulation of ESG Data and Ratings providers based on IOSCO's policy recommendations. We encourage the Singaporean authorities and the industry to continue to coordinate with their international counterparts to avoid a fragmented approach. This is particularly important given the global nature of the market for ESG ratings and data products.

ISDA supports the introduction of the CoC. Such a Code will act as an interim solution ahead of the implementation of a regulatory regime in Singapore (as referenced in the Consultation Paper).

ESG ratings and data have a critical role in the allocation of capital and provide financial market participants with benchmarks to enable investment decisions, particularly given the rise in interest regarding sustainability matters. It is therefore important for these assessments to be produced to a high level of quality and integrity.

The relevance of ESG ratings and data providers in financial markets has increased significantly over the last few years and this is expected to continue. The increase in focus on ESG factors amongst investors, the increase in commitments by issuers and the increase in the application of ESG regulatory and disclosure requirements all drive the importance of ESG ratings in Singaporean financial markets. ESG ratings and data are therefore very relevant to the Singaporean financial market and market participants. This is because they provide a means of assessing investments from a perspective which presents both risk management and upside opportunities.

ESG ratings and data are increasingly being used to structure ESG financial services and products. ISDA members rely on ESG ratings and data for the construction of indices and derivatives in structured products. They can also be used to determine pay-outs of ESG-linked derivatives. Whilst the market for ESG linked derivatives can be characterised as nascent at this stage, we expect further growth in this segment of the market, with ESG ratings as 'inputs' becoming more important over time.

Derivatives enable more capital to be channelled towards sustainable investments; help market participants hedge risk related to environmental, social and governance (ESG) factors; facilitate transparency, price discovery and market efficiency; and contribute to long-term sustainable investments.

In January 2021, ISDA published a paper outlining the range of product structures and transaction types that comprise the universe of ESG-related derivatives, including Sustainability-Linked Derivatives (SLDs); ESG-related CDS indices; exchange-traded derivatives on listed ESG-related equity indices; emissions trading derivatives; renewable energy and renewable fuels derivatives; and catastrophe and weather derivatives (see ISDA publication: *Overview of ESG-related Derivatives Products and Transactions, ISDA, January 2021*).

In the context of SLDs (see ISDA publication: *Sustainability-linked Derivatives: KPI Guidelines, ISDA September 2021*), having an independent third party minimizes the risk of moral hazard and the potential for conflicts of interest to arise given the economic consequences of meeting or failing to meet sustainability Key Performance Indicators (KPIs). It may also minimize potential disputes. The involvement of a third party will be intrinsic where the KPI is linked to a counterparty's general ESG rating. This is because the counterparty will be deemed to have met the KPI if it is granted a specific rating by the ESG rating provider. In other cases, the third party will need to be specifically chosen and appointed by the counterparties. This third party may be (without limitation) an auditor, environmental consultant or expert in the particular subject matter of the KPI.

It is therefore important that the market has confidence in the quality and reliability of ESG ratings and data products and that there is appropriate transparency, comparability and reliability of ESG ratings and data. Investors that use an ESG rating and data product as an input for capital allocation should have reliable and transparent information about the basis for that rating. A lack of transparency and reliability could harm investor protection and an orderly functioning of the market. By way of example, ESG ratings of voluntary carbon credits would certainly benefit from greater transparency over methodologies and improvement of governance in the context of strengthening the integrity of the voluntary carbon market.

In particular, ISDA members have the following concerns with regard to the ESG rating and data products that they currently use, and where this CoC could bring positive impacts:

- A need for greater transparency of methodologies: this is critical to enable users to understand what ESG ratings are measuring. This should cover not just the high-level methodology but the detailed assessments that have taken place against each score, including the rationale.
- As identified in the IOSCO Report, there is significant variation in ESG ratings due to different weightings of different ESG factors, leading to a low correlation of ESG scores from different providers for the same company. While there may be valid reasons for different ratings due to differences in focus, methodology and sources of data, there should be transparency of rating purpose and meaning (i.e. is the rating measuring impact, risk or opportunities), methodologies, and data sources to facilitate comparability of ratings. Our members generally observe a lack of alignment of definitions and approaches. This variability, combined with a lack of clarity on the methodologies used, makes ratings difficult to compare.
- A lack of coverage of ESG ratings and data products, as well as the need to ensure that providers have sufficient resources and analysts have sufficient expertise: In some cases, a perceived lack of resources has led to use of over-simplified tools with little human analysis which is likely to be particularly necessary for complex industries. Resourcing should also be commensurate with the number of companies rated. ESG rating providers should ensure that the quality of the information provided to the market and investors is not compromised by the number of companies rated and by increasing number of requests coming from their clients and rated corporates. Transparency over sources of data should enable users to assess the degree of analysis in the rating.
- Issues with some ESG rating and data providers' governance, for example that companies may not be aware that they are rated by certain ESG rating providers while others are not updated when there are changes to their rating, can lead to asymmetry of information and inaccuracies in reporting. The escalation process to report inaccuracies with unsolicited ESG ratings can be slow and time consuming for rated corporates, and in some cases may imply obtaining a solicited (fee paying) ESG rating, which means that reports that are be available to investors might not be corrected or updated for some time.
- While the CoC should be mindful of enhancing the transparency of methodologies, as well as the sources of data used (e.g. data collection and management and client-agency interactions), it should

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not stifle the innovation of methodologies used by rating providers nor should regulation intervene in methodology design..

- The CoC should be based on the overarching principle of transparency to allow for multiple operating models and methodological approaches to co-exist.
- As identified in the IOSCO Report, there could be a risk of conflicts of interests arising which need to be appropriately addressed. For example, some issuers with unsolicited ratings face having to pay for a solicited rating if they wish to update or correct an unsolicited rating. We also support the introduction of measures to help ensure that relevant staff refrain from any securities or derivatives trading presenting inherent conflicts of interest with the ESG ratings and data products.