ISDA commentary on the European Commission's proposal on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

The International Swaps and Derivatives Association (ISDA) welcome the opportunity to comment on the European Commission's proposal on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities**.**

General Remarks

ISDA supports the introduction of a regulatory framework for ESG ratings in the European Union and elsewhere based on the recommendations of the IOSCO report on ESG Ratings and Data products ('IOSCO report'), with a view to avoid unnecessary market fragmentation. We encourage policymakers and regulators to continue this collaborative approach at the global level.

The European Commission's proposal is a good starting point. We support the EC's focus on enhancing transparency of methodologies and addressing conflict of interest while avoiding interference with ESG ratings providers' methodological freedom.

ESG ratings perform an increasingly important role in the allocation of capital and provide investors with a useful tool to enable investment decisions and assess ESG performances. A proportionate regulatory framework could underpin trust among investors in ESG ratings while allowing the nascent market to further develop and innovate ESG products.

It should also be noted that the quality of ESG ratings (in fact, ESG financial products more broadly) will highly depend on the quality of raw ESG data. We also welcome the global work underway to improve corporate sustainability disclosures, which should improve the availability and quality of ESG data. This should in turn enhance the reliability of ESG ratings.

As recognised in the IOSCO Report and Recommendations (see IOSCO Recommendations 8 and 9), it is important to ensure efficient and effective interactions between ESG Rating Providers and rated entities. This has also been reflected in, for example, the draft UK Code of Conduct[1]. ISDA believes that the proposed regulation should also include provisions to promote effective interaction between ESG rating providers and covered entities, in order to enhance the quality and reliability of ESG ratings. For additional rigor and precision, it should be specified that users must receive sufficient and clear information on fees and pricing drivers from ESG Data Providers and ESG Rating Providers to be able to make informed choices.

ISDA members increasingly use ESG ratings as well as ESG data to structure ESG financial services and products. In a derivatives context, ESG ratings can be used for the construction of indices and derivatives in structured products. ESG ratings may be used to determine pay-out 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.

[1] See principle 6 of draft DRWG Code of Conduct https://www.irsg.co.uk/assets/Papers/DRWG-ESG-Code-of-Conduct-Draft-July-2023.pdf

Scope

We understand that the EC intends to create a regulatory framework for ESG ratings and does not intend to scope-in 'ESG data products'. We understand that Article 2(2)(2) aims to ensure that other ESG products 'incorporating elements of ESG ratings' are excluded from the scope of this regulation. However, we are of the view that a specific exclusion for financial products whose transparency and integrity are supervised under existing regulatory frameworks would enhance legal clarity for market participants and avoid costly and unnecessary overlapping regulatory frameworks.

Therefore, it is essential to review the proposed scope of the regulation to ensure that it does not unintentionally capture certain products or the activities of regulated financial undrtakings such as banks, investment firms, asset managers and benchmark administrators. It is not clear in the proposed draft that products which are currently governed by separate regulatory frameworks, such as investment research and benchmarks, are expressly excluded from scope of the definition of ESG ratings. We strongly consider that financial products whose transparency and integrity are supervised under existing regulatory frameworks should not fall within scope of the proposed regulatory framework for ESG ratings. Absent this clarity, there is material risk of misalignment between the existing regulatory regimes resulting in members being regulated at both Member State and ESMA level under different regulatory frameworks for the same product. IOSCO recognised the importance of enhancing the transparency, reliability and comparability of both ESG ratings and ESG data products. We understand that the EC has decided to prioritise regulation of ESG ratings providers. We recognise that efforts to enhance the availability and comparability of ESG corporate reporting should address some challenges in the ESG data products market e.g. through the implementation of CSDR and ESRS, TCFD and forthcoming Sustainability Disclosure Standards based on the ISSB standards, and similar international and regional initiatives. Nevertheless, it is critical that the appropriate steps are taken to reduce the risk of unintended greenwashing by both ESG ratings and data providers, and we consider that it is important for the EC to continue to assess the market for ESG data products and to keep the need for taking regulatory action, where appropriate, under legislative review.[2]It would be helpful if the co-legislators could explicitly clarify that the activity of "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 scope in Article 2(1) as applying to "ESG ratings issued by producers of ESG ratings" would further clarify this.

In the context of OTC traded Sustainability linked derivatives (SLDs), financial market participants may use ESG ratings or other metrics, with a view to offer clients a tailored financial product. Therefore, ESG ratings created by entities solely for use by that entity should be excluded from the regulation, as long as they are not marketed externally to a third party as ESG ratings.

[2] Also see ESMA's progress report on greenwashing: https://www.esma.europa.eu/press-news/esma-news/esas-put-forward-common-understanding-greenwashing-and-warn-risks

Similarly, ESG ratings produced, used and disclosed for complying with regulatory requirements such as disclosures mandated under exiting regulatory frameworks should be excluded from the regulation.

In light of the above, we would like to seek clarity with respect to Article 2(2)(a) – (b).

- The use of the undefined terms 'public disclosure' and 'distribution' could lead to diverging interpretations, particularly as these terms are either defined in other legislation or have a meaning that is understood in the context of that legislation. We would like to seek clarity that the provisions do not capture ESG ratings created for the purpose of bilateral, tailored transactions (for example, ESG linked derivatives). We would therefore propose aligning the approach with the IOSCO definition of ESG ratings, which refers to ratings that are marketed as having an ESG focus, with further precision to be provided on these terms during the Level 2 process.
- In particular, the interpretation of 'public disclosure' should be further defined. For example, would an offering of an ESG rating on a password protected website also be deemed 'public'? This would not be the case in the context of other financial services legislation (e.g., this would not be considered adequate public disclosure for the purposes of MAR or MiFID reporting). If a different interpretation is intended in the context of ESG ratings, either a different term should be used or "public disclosure" should be further defined.
- Furthermore, the EC should provide clarity on the extent of the products and services that are intended to be excluded under Article 2(2)(e). Absent these refinements, the risk of unintentionally capturing such ESG financial instruments is made more acute by the proposed inclusion of 'ESG score' within the definition of 'ESG rating', given the expansive definition of ESG score proposed by the EC. Similarly, the EC should consider refining the definitions of 'scores' and expressly refer to 'ESG scores' rather than any quantitative (financial or non-financial) score.
- Furthermore, ESG products that are already regulated under existing harmonised EU regulatory frameworks should be explicitly scoped out from the proposed ESG rating regulation.

The definition of 'ESG rating' (see below) and establishment of a common understanding among market participants and regulators will be key for the establishment of a proportionate regulatory regime, enhancing the trust in the ESG ratings market while providing needed legal clarity with respect to the scope.

ISDA also considers that the collection and assessment of ESG controversies should be considered by the co-legislators. Whilst we understand there has been no proposal to exclude controversy reports, screenings or norm-based research from the regulatory intervention being consulted on, we believe their express inclusion would benefit users and providers of ESG ratings.

Controversy reports and alerts, also known as norm-based research, are typically produced by ESG ratings and data product providers for two purposes: i) as standalone controversy reports or alerts which may be used by investors as additional screening mechanism, or by proxy advisors when producing recommendation reports; and ii) as data points considered as part of an ESG rating or scoring process. Like with ESG Ratings, methodological approaches underlying controversy reports and alerts are very diverse, which, when combined with issues regarding the availability, quality and comparability, can result in low correlation and high divergence between providers even where products are aiming to address the same objective. To develop trust and promote confidence in the ESG ratings space, both purposes should fall within the regulatory perimeter. We would note that controversies are often assigned their own rating (e.g., severe / moderate) based on the rating agencies' own methodology i.e., rating providers are not just providing data, they are actively providing a judgement on the data before distributing it to the market.

Furthermore, we consider that the use of controversies should be a particular focus where systems and controls are required alongside greater engagement with rated entities. Experience of members as rated entities is that controversies can have a significant weighting on overall ratings, often based on media reports which may not be reflective of actual impacts, often leading to incorrect interpretation with a lack of opportunity for rated entities to correct or respond. In addition to transparency over the methodology, we support the introduction of provisions requiring ESG rating providers to apply a due diligence process with respect to controversies, in order to (i) assess the sources and seriousness of controversies, (ii) to give the rated entity a right of response and (iii) to give due consideration to remedial measures taken by the rated company.

Definitions

ESG rating

ISDA supports the definition of 'ESG rating' in Article 3(1), which is based on the definition of the IOSCO report. However, we would suggest that the definition is amended to refer to ratings that are "marketed to third parties" (rather than "provided to third parties"), in order to align with the IOSCO approach and also to ensure that the scope only captures ratings that are intentionally marketed and not ratings that happen to become available to third parties.

We think the co-legislators should follow the EC's approach in this regard and ensure that the definition does not inadvertently cover ESG financial instruments subject to other regulatory frameworks or not understood by market participants as an 'ESG rating'. As mentioned above, Article 2(2)(e) referring to 'products or services that incorporate an element of an ESG rating' could be further defined to avoid inadvertently scoping-in of certain ESG-related products.

Rating analyst

We would support aligning this definition with the equivalent decision used in the Credit Rating Agencies Regulation (on which this definition is based), and amending it so that a rating analyst is a person who performs analytical functions **necessary for** issuing ESG ratings.

Authorisation

As discussed, we support a broad regulatory framework for ESG ratings and see merits in authorisation at the European Level. We would therefore recommend a streamlined authorisation procedure for firms which are already subject to EU financial services supervision, whereby they would not have to re-submit all the information they have already submitted as part of their authorisation process.

As mentioned above, we welcome the exclusions for private ESG ratings and ratings produced for internal purposes or for providing in-house financial services and products, subject to the requests for clarification set out above.

We would also suggest that it may be appropriate to include exclusions for:

- ESG ratings produced by any entity (whether EU or non-EU) that are used for internal purposes or for providing in-house financial services and products. The key point is that the ratings are produced for internal purposes, not that they are produced by EU regulated financial undertakings. If an unregulated entity produces ratings for internal purposes, these should also fall outside of the scope of the regulation.
- ESG ratings where the rating provider is unaware and could not reasonably have been aware that its ratings are being provided or used in the EU (in line with the similar exclusion under the Benchmarks Regulation).

Third country regime

We note that the EC's suggested third country regime is based on the EU BMR. It should be noted that the current BMR third country regime has proven to be unworkable, requiring a series of extensions of the BMR transition period. We understand that the EC is likely to reform the current third country approach for firms under BMR. While we recognise that the ESG rating markets is not the same market as benchmarks (ESG rating markets is more concentrated), the following points should be observed with regard to the authorisation for third country firms:

- Equivalence: Given that the EU is likely to be a frontrunner with respect to ESG ratings legislation, there will be very few legislative frameworks to be deemed equivalent. Furthermore, scopes of regulations may differ hence equivalence will not bring all ESG ratings of a specific third country in scope. Therefore, we expect the coverage of ESG ratings covered by equivalence to be slim.
- Endorsement: Article 10 allows EU domiciled ESG rating providers to endorse third country ESG providers 'belonging to the same group'. Therefore, this option does not seem to be available for 'pure' third country providers without a residence in the EU. Furthermore, it appears that endorsement would require the endorsement of ESG ratings on a standalone basis (rating by rating) rather than an endorsement of the ESG ratings provider's activities (entity by entity). We would recommend an entity-by entity approach to reduce the burden for entities and supervisors.
- Recognition: In light of the above, third country firms without an EU entity would likely rely heavily on recognition as the route to authorisation. Similar to the BMR, recognition requires a 'legal representative' which shall be in turn 'accountable to ESMA'. The issue of arising legal liabilities will disincentivise EU entities to take on the role as legal representative unless the third country firm is willing to cede governance to the EU entity.

We therefore recommend an alternative approach, such as the introduction of substituted compliance provisions based on third country providers complying with the IOSCO recommendations (as demonstrated by a positive assessment provided by their local supervisory authority.

Conflict-of-interest

Article 15 of the EC proposal sets out activities an ESG ratings provider shall not provide, with a view to avoid conflict-of-interest situations. Given that the definition of 'ESG rating providers' in Article 3(4) refers to legal persons, we interpret the requirement as a strict legal separation (i.e., requiring ESG ratings to be provided in a separate legal entity from any of the prohibited activities).

Whilst we agree that conflicts of interest need to be addressed and managed if they arise, we do not think that a strict legal separation is required to manage conflicts. Instead, entities which produce ESG ratings need to ensure they can identify, avoid and/or appropriately manage, mitigate and disclose actual or potential conflicts of interest that may compromise the independence and objectivity of such ESG ratings. It should also be noted that provision of ESG ratings is a relatively small business in many cases, and that often these business lines are dependent on funding from other areas of the business. Setting up separate legal entities to act as rating providers would entail a significant administrative burden without necessarily addressing actual conflict-of-interest situations. Other regulatory frameworks, such as the BMR and the credit rating agencies regulation, do not require a legal separation and we do not see any reason why ESG ratings should be subject to 'stricter' requirements than other financial services. Unless mitigated, it is likely that many current ESG rating providers will not consider that a standalone entity is viable, resulting in a reduction in competition in the ESG rating markets in the EU.

Methodological freedom

In line with recommendation 3 of the IOSCO report, we strongly endorse the EC's approach with respect to methodological freedom and ESG rating providers' independence. We think that the regulation should enhance the transparency of methodologies thereby also enhancing financial services users' understanding of the diversity of ESG ratings. In this context, we particularly appreciate references in Article 14(1) and 26, clarifying that ESG ratings should not be subject to political or economic interference.

ESG ratings are used for a variety of purposes. The diversity of ESG ratings reflects this and any form of regulatory interference in ESG rating providers' methodological freedom should be avoided.

Interaction between providers and rated entities

As recognised in the IOSCO Report and Recommendations (see IOSCO Recommendations 8 and 9), it is important to ensure efficient and effective interactions between ESG Rating Providers and rated entities. This has also been reflected in, for example, the draft UK Code of Conduct . ISDA believes that the proposed regulation should also include provisions to promote effective interaction between ESG rating providers and covered entities. This should in turn enhance the quality and reliability of ESG ratings. For additional rigor and precision, it should be specified that users must receive sufficient and clear information on fees and pricing drivers from ESG Data Providers and ESG Rating Providers to be able to make informed choices.

Transitional provisions

Article 50 of the proposal suggests a 6-month application deadline. We believe that this timeline is unrealistic and requires a revision. Prior to compliance, market participants will need to address operational, legal and other challenges (not least if they are required to establish new legal vehicles and transfer business and staff across to those vehicles, or hire new staff where the conflict of interests requirements mean that existing staff are unable to work for both entities). A short 6-month implementation period would therefore create undue non-compliance risks. Furthermore, the ESG ratings regulatory framework requires further Level 2 provisions subject to the ordinary process, i.e., ESMA drafts, consultation, EC adoption and co-legislators' scrutiny.

Therefore, we would recommend adapting the implementation timeline to18 months. Nevertheless, we encourage the industry and regulators to implement the regulation as soon as practicable due to the increasing importance of ESG ratings for ESG markets more broadly.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on www.isda.org.