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ISDA RESPONSE TO THE DRWG CONSULTATION ON THE DRAFT VOLUNTARY CODE OF CONDUCT FOR ESG RATINGS AND DATA PRODUCT PROVIDERS

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Response to the DRWG consultation on the Draft Voluntary Code of Conduct for ESG Ratings and Data Product Providers

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to the ESG Data and Ratings Working Group's (DRWG) Draft Voluntary Code of Conduct for ESG Ratings and Data Product Providers.

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 EU, Hong Kong, Japan, Singapore 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 UK financial services regulators 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 a Code of Conduct for ESG ratings and data providers. Among other things, such a Code will act as an interim solution ahead of the implementation of a regulatory regime in the UK for ESG ratings providers.

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

The role 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 and data in UK financial markets. ESG ratings and data are therefore very relevant to the UK 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. In particular, 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.[1]

In the context of SLDs[2], 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 or data product. 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 Code of Conduct could bring positive impacts:

- A need for greater transparency of methodologies: this is critical to enable users to understand what ESG ratings or data products (such as estimates) are measuring. This should cover not just the high-level methodology but the detailed assessments that have taken place against each score or estimate, 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

[1] Overview of ESG-related Derivatives Products and Transactions, ISDA, January 2021
[2] Sustainability-linked Derivatives: KPI Guidelines, ISDA September 2021

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. The same issue of variability combined with a lack of clarity on the methodologies used, makes also “built-up” ESG Data (such as estimates, or sectoral data) difficult to compare on a given issuer or sector.

- 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 or part of sectoral data. ESG rating and data product providers should ensure that the quality of the information provided to the market and investors is not compromised by the number of companies rated or sampled in sectoral data 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 Code of Conduct 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 not stifle the innovation of methodologies used by rating or data product providers .
- The Code of Conduct 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.

Scope

ISDA recognises 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. ESG ratings and data providers should be encouraged to adhere to the Principles as much as appropriate to their business structure in order to ensure consistency across the market. This 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. A central authority should collect data on the level of adherence to the Code of Conduct to mark the consistency of adoption across the industry.

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.

Exclusions

We recognise that this is a voluntary code. However, we agree that the following entities and products should be identified as excluded from its scope:

- Credit Rating Agencies in respect of their offering of credit ratings (including those credit ratings that include consideration of ESG factors). Where Credit Rating Agency groups own entities that offer ESG rating/scores or ESG data products, those entities would fall within the intended scope;
- Entities who produce ESG ratings/scores or ESG data 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 and are therefore not provided or marketed to third parties;
- Entities whose commercial activities involve ESG consulting services, but that do not involve the provision of any ESG rating/score or ESG data product;
- UK and third country regulated financial institutions as, considering the IOSCO final report, these institutions are not the target market for this regime. The IOSCO final report considers ESG ratings and data providers that are *generally not subject to regulatory oversight*[3] however UK and third country financial institutions (such as banks, investment firms and asset management companies) may already be within the regulatory perimeter (and subject to regulatory oversight) in order to provide their services and products, in addition to being subject to ESG-specific laws and rules (e.g., the upcoming anti-greenwashing rule, ESG Sourcebook requirements as well as other regimes etc). This illustrates that financial institutions are likely already engaged in a developing ESG regime which aims to address issues such as those raised in the IOSCO final report in respect of ESG ratings and data products (such as governance, conflicts of interest, transparency and greenwashing) and therefore do not need to be subject to additional oversight and the proposed requirements considered under this regime. Other materials[4] support the view that this regime is focussed on those larger providers (such as credit rating agencies, exchanges and data and index providers) and smaller, more specialised firms which provide large or specialised ESG-related products[5] as opposed to already-regulated financial institutions

[3] The Board of The International Organization of Securities Commissions 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers – Final Report' (November 2021) FR09/21, pg. 4

[4] See generally: (1) the impact assessment of the European Commission's ESG ratings proposed regulation ("*this initiative will target the specialised entities providing ESG ratings to the public or to subscribers*"); (2) the European Union Study on Sustainability Related Ratings, Data and Research which categorises investment banks as *investors*, and separately from sustainability-related product and service providers, as investment banks will "*assess sustainability-related data and information to make buy, hold and sell recommendations to investors*" (see pages 15-16); and (3) ESMA's 2022 work on the topic of ESG ratings providers, which is cited as a stakeholder consultation relevant to the European Commission's proposal - namely, ESMA's call for evidence on the market characteristics for ESG rating providers in the EU describes banks and investment firms as *users* of ESG ratings, rather than as providers (see page 2) and, furthermore, section 3.6 of the ESMA letter detailing the outcome of its call for evidence specifically identifies the main ESG ratings providers which *users* cited as their providers.

[5] The Board of The International Organization of Securities Commissions 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers – Final Report' (November 2021) FR09/21, pg. 7 (Table 1)

which have traditionally been viewed as investors or users of these products, and not providers.

- Investment research products;
- Financial benchmark administrators;
- Financial products which are screened for ESG characteristics (whether this is a fund or another product offering, such as eligible collateral).

We fully support that entities who produce ESG ratings/scores or ESG data products that are used or consumed only within the same corporate group of affiliated companies are specifically excluded from the Code of Conduct's application. However, we are concerned that the reference to 'not provided or marketed to third parties' could still unintentionally include proprietary ESG ratings/scores if these are used in marketing materials of financial products or are included in reporting to clients. As such, we urge DRWG to ensure that entities using a proprietary framework to produce ESG ratings/scores will only be in scope of the Code of Conduct if these ratings/scores are specifically marketed on a commercial basis (i.e. for a charge) and not simply because these ratings/scores are used as part of marketing a financial product. Manufacturers of these financial products are already regulated entities and these financial products are already subject to extensive regulation and disclosure requirements. It would be disproportionate to expect these already regulated entities, to also be covered by the Code of Conduct. Furthermore, for these entities, the financial product manufactured is the end product and not the proprietary scores/ratings.

We do not agree that proxy advisory services should be excluded from the scope of the Code. The inclusion of ESG assessments and qualitative scores in proxy reports is a relatively new, but increasing, phenomenon and it is not clear whether the Proxy Advisors (Shareholders' Rights) Regulations 2019 anticipated this development. Whilst we agree there should not be significant overlap in requirements, if proxy advisory services are out of scope of the Code as anticipated in this consultation, this could create a gap where ESG assessments included in proxy reports remain out of scope of the Proxy Advisors Regulations and do not benefit from the proposed guidance on quality of data, transparency or systems and controls. Whilst existing legislation does require proxy advisors to publicly disclose and report against their codes of conduct (or explain why they do not have one), it is not sufficiently clear that these ESG features are in scope of the Proxy Advisors Regulation.

Furthermore, whilst proxy advisory services are (a) provided for a specific purpose (informing shareholders); and (b) to some extent already regulated, many of the market failures for ESG Ratings could also apply to ESG components of proxy reports. Some proxy agencies produce reports and subsequently offer additional services to help companies improve or provide an explanation / rebuttal of the rating or conclusions that the proxy agency itself has issued. The proxy advisory and ESG rating processes also share some similarities. As such (and given the influence proxy agencies have, including their impact on Annual General Meetings) we believe proxy advisor services should not be excluded from the Code's scope.

Controversies alerts and second party opinions (SPOs)

ISDA recommends that the Code apply to second party opinions and controversies alerts. 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 ratings and data space, both purposes should fall within the scope of the Code.

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

Specific comments on the Principles

Principle on Securing Quality (Systems and Controls)

As part of the actions within this Principle, we believe it is important that ESG ratings and data products providers ensure that they have appropriate quality-check mechanism. According to IOSCO recommendations, these checks can include, depending on the process: scrutinising for plausibility, screening for potential incoherencies, statistical and logical checks (looking for abnormal spikes and outliers, either at the company or/and at the industry level), checks against other sources such as governmental databases, and deviations against a peer group or against previous years. The quality-check mechanism can also include checking on a regular basis whether there would be any apparent discrepancy between the evaluation results and the service provision methodologies.

We believe that this Principle should also reference outsourcing. Specifically, where ESG evaluation and data providing services are outsourced, the outsourcing service provider should be expected to comply with the relevant actions included in this Principle.

Principle on Conflicts of Interest

As part of the actions within this Principle, establishing a firewall between sales and evaluation divisions should be added. A concrete example of this firewall is assigning a staff member to conduct evaluation, separate from the staff member responsible for sales of ESG evaluation and data services.

Market Clarity

It is clear that ESG ratings can influence market movements at the point of publication. This can be attributed, at least in part, to the lack of prior warning of when an ESG rating will be revised or released by a provider. ISDA understands that companies may have different rating cycles and timings, and that scheduling ratings can be challenging. However, we suggest that ESG rating providers should specify when they will update ESG ratings and make this information accessible to all participants simultaneously, similar to Credit Ratings. This could be achieved by publishing a schedule that stipulates a cadence / exact date for market participants.

Consultation questions

Interoperability

1. **How would the proposed scope of this Code of Conduct interact with initiatives related to ESG ratings and data products in other jurisdictions, such as existing or proposals for regulation or Codes of Conduct? Are there any particular issues that you think might limit its international interoperability with other similar initiatives?**

The voluntary nature of the Code of Conduct should prevent conflicts between the Code and initiatives in other jurisdictions, including existing or proposed regulation or voluntary codes of conduct. However, there are some factors that could potentially limit its international interoperability with other similar initiatives, including:

- The fact that the Code is intended to apply broadly without territorial scope means that it will potentially come into competition with other similar regulation or voluntary codes. The voluntary nature of the Code means that this should not present a hard legal conflict, but it may leave providers in a position where they are potentially expected to comply with multiple competing codes, leaving users uncertain as to whether compliance with one code is preferable to compliance with another, and whether one code is "more" consistent with IOSCO’s recommendations than another.
- Such conflicts are likely in particular where the scope of the Code goes beyond the scope of other voluntary codes or local regulation. For example, most local codes or regulation seek to exclude activities that are already subject to regulation locally.

2. Taking into account the Code of Conduct’s degree of alignment with IOSCO recommendations and the consideration it gives to other international approaches (such as Japan’s and Singapore’s), do you think the Code of Conduct could and/or should serve as a global baseline for ESG ratings and data product providers?

ISDA welcomes the work undertaken by the IRSG to build on the IOSCO recommendations (and in particular the helpful mapping table against the IOSCO recommendations and the consideration given to the approaches proposed in Japan and Singapore). ISDA notes that there is a precedent for IOSCO setting similar global standards and for those being accepted as the basis for assessing substituted compliance or equivalence in connection with cross-border provision of services. To enable an internationally agreed approach, these would need to be endorsed by IOSCO, taking into account the most recent developments in regulating these products.

Differentiation of ESG Ratings and Data products

3. Noting the distinction drawn between ESG ratings and data products, is the Code of Conduct sufficiently clear on how its Principles specifically apply to ratings products and/or data products?

As drafted in the consultation, the Code of Conduct is clear on how its Principles specifically apply to rating products and/or data products. Should this evolve as the Code is implemented, any changes should be clearly illustrated to the industry.

We understand that once an ESG ratings or data product provider has signed up to the Code of Conduct, this will be followed by an implementation period. The implementation period for ESG ratings providers is six months and the implementation period for ESG data products providers is twelve months. We strongly disagree that ESG ratings and data providers are treated differently in terms of implementation period. This is inconsistent with the statement in the Code of Conduct that it is not necessary to draw specific differences between ratings and data products. Our preference is for the implementation period to be limited to six months for both ESG ratings and data product providers.

Forward looking information

4. Some stakeholders have encouraged there to be an explicit statement as to whether a methodology incorporates forward looking information, such as transition plans. We would welcome views on the proposal to include an action encouraging such disclosure.

ISDA generally advocates for enhanced transparency in methodologies, which can enable users to make more informed decisions on capital allocation. Other voluntary codes of conduct (e.g., the proposed code that Singapore's MAS is currently consulting on) propose best practices on disclosure of how transition risks and opportunities are factored in, and ISDA members support this approach.

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.

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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 77 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 the Association's website: www.isda.org.

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