

## ***Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related services***

This paper aims at contributing to the current debate about the accuracy, reliability and transparency of Environmental, Social and Governance (ESG) data, ratings, and related services offered by Sustainability-related service providers to financial market participants.

### **In this position paper the AMF and AFM note that:**

- **The demand for ESG data and services is surging among investors and asset managers looking for sustainable investments.**
- **Investors and asset managers need reliable ESG data and ESG-related services to support the shift towards greener economies and comply with European regulatory framework on sustainable finance.**
- **Sustainability-related service providers (SSPs) remain largely unregulated.**
- **Lack of transparency on methodologies of SSPs, and risk of conflicts of interest, lead to risks of misallocation and missed opportunities.**

### **Therefore the AMF and AFM advocate:**

- **An ad-hoc European mandatory regulatory framework for SSPs.**
- **A framework requiring establishment of SSPs in the EU and their supervision by ESMA.**
- **A regulatory focus on transparency about methodologies, potential conflicts of interest, and governance and internal control requirements.**
- **Allowing for proportionality and continued market innovation.**
- **A step by step approach: a set of core requirements for SSPs that serves as a starting point, to be reviewed periodically taking into account market developments and, where appropriate, complemented by additional measures.**

Based on their regulatory experience and detailed analysis of this market, the *Autorité des marchés financiers* (AMF) and the *Autoriteit Financiële Markten* (AFM) **propose a European regulatory framework for providers of sustainability-related services** aimed at preventing misallocation of investments, greenwashing and ensuring investor protection. This new regulation should become part of **the Commission's renewed sustainable finance strategy** to strengthen and expand the overall framework for sustainable finance.

Reaching the ambitious 2030 climate and energy targets will require additional private investments. The European Green Deal<sup>1</sup> estimates that we will need to mobilise €260 billion a year by 2030 to finance the transition. **Investors and asset managers will need more reliable ESG data to support the shift towards greener economies.** At the same time, increasing regulation on sustainable finance also sustains the growing demand for ESG data by investors. As data reported by issuers is still incomplete,

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<sup>1</sup> 4 2.2.1. "Pursuing green finance and investment and ensuring a just transition", The European Green Deal, 11.12.2019.

and as investors rely on data, analysis and services offered by sustainability-related services providers (SSPs)<sup>2</sup> to close the data gap. The growing demand fosters innovative service offerings among such actors. SSPs may indeed offer ESG ratings, but they are also involved in a variety of other services such as the provision of raw ESG data, scoring, controversies research<sup>3</sup>, screening or taxonomy-related tools.

**While those providers remain largely unregulated, their influence is expected to grow considerably.** Recent estimations predict that ESG data and services market *“could more than double to over \$5 billion by 2025 (...), as institutional investor interest grows in the wake of the Covid-19 pandemic”*<sup>4</sup>. The European Commission has also acknowledged the importance of the matter and has commissioned a study on sustainability ratings and research in order to explore this market in detail and identify potential shortcomings (Action 6 of the Commission’s Action Plan on sustainable finance published in March 2018).

**The growing importance of ESG data and services also uncovers potential risks for investors and asset managers looking for sustainable investments.** In particular, the lack of transparency concerning SSPs’ methodologies as well as the role of estimates make it difficult to correctly appreciate what the ratings reflect. This can lead to misallocation of investments or even greenwashing, jeopardising the Commission’s objectives on sustainable finance. Furthermore, SSPs can assume different roles such as consultant, data provider or rating agency, and represent diverse interests from issuers’ to investors’. It is therefore important that potential conflicts of interest are managed and averted, ensuring an appropriate level of market transparency.

In this paper we first discuss the growing role of sustainability-related data and services in the financial system in greater depth. We then raise a number of potential risks and challenges these developments pose. Finally, **we go into the envisaged European regulatory framework which is aimed at strengthening the overall framework and support investor confidence in sustainable finance.**

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## What is the role of sustainability-related data, analysis and services in the financial system?

- ▶ **Investors’ interest for green, ESG and sustainable investments and engagement is booming.** In 2020, the UN Principles for Responsible Investment’s initiative (UN PRI) counts more than 3 000 signatories representing over 100 US\$ trillion of assets under management<sup>5</sup>. This trend brings with it a certain number of risks including those of greenwashing, and mis-selling, as well as those involving the inaccurate assessment of risks, in particular if ESG reported data is inaccurate or

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<sup>2</sup> For the purposes of the discussion in this paper, we will refer to these service providers as SSPs but do not intend to create a definition beyond discussion purposes.

<sup>3</sup> Controversies Research consists in apprehending allegations and disputes that could impact the reputation and legal security of companies. As the information is generally not available in annual reports, agencies review press and NGO reports, usually using artificial intelligence. The results of these investigations are widely used by investors and may also be included in ESG ratings by some agencies; it is never comparable between agencies.

<sup>4</sup> UBS Evidence Lab

<sup>5</sup> <https://www.unpri.org/pri/about-the-pri>

incomplete. Accurate and reliable ESG information is thus key for this trend to continue and the market to develop in an efficient and effective manner.

- ▶ **The demand for ESG data and services is surging among investors and asset managers looking for sustainable investments. ESG data play an important role in matching supply and demand for sustainable investment.** At the same time, ESG data is relevant for all investors, in order to allow for the integration of sustainability risks and opportunities in the decision making process, to disclose such risks where relevant, and to properly assess the long-term values of their (potential) investments. The key challenge is to reliably assess issuers' ESG performance. This is a challenge because data involving ESG performance is disparate and hence difficult to compare, and no common definition exists yet of what ESG performance exactly entails. Conversely, the lack of a common framework also complicates the access to and analysis of issuers' reporting on ESG performance. To close this gap, ESG ratings and other ESG tools have emerged to make ESG performance more easily accessible. In doing so, SSPs emerge as a crucial link between demand and supply of sustainable investment. Such ratings may, among others, underpin (both positive and negative) screening strategies as well as engagement strategies by asset managers, investment funds and ETF-providers.
- ▶ **There is a variety of ESG ratings and ESG-related tools and services available in the market.** The demand for ESG data and services varies among investors, from those who are more sophisticated and have developed in-house competencies and resort to providers to source data, to those who are passive investors relying on ESG benchmarks to constitute portfolios. Hence the current offering in the market encompasses a wide range of tools and services. A recent study<sup>6</sup> carried out within the context of this analysis identifies more than 10 categories of products including scores<sup>7</sup> and ratings, together with scenario analysis, screening lists, carbon data, ESG benchmarks and taxonomy-related products. In the current state of the market, ESG ratings and scorings tend nonetheless to remain the core products used by investors.
- ▶ **The emerging European regulatory environment on sustainability, as it contributes to and guides this green “shift”, lends strength to the role of SSPs.** New European regulations put the integration and disclosures of ESG performance and risks at the core of the new financial architecture; this tends to leave financial institutions often to rely on external third parties for relevant data and analysis. In the years to come, while the revision of the Non-Financial Reporting Directive and the European single access point (ESAP)<sup>8</sup> should contribute to enhance the availability and comparability of corporate non-financial information, it is likely that financial institutions will still rely on external third parties to make better investment decisions and comply with their reporting obligations.

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<sup>6</sup> AMF's Overview of ESG actors, products and services.

<sup>7</sup> Article 3 of the CRA Regulation introduces a distinction between scores and ratings in the area of credit : “‘credit score’ means a measure of creditworthiness derived from summarising and expressing data based only on a pre-established statistical system or model, without any additional substantial rating-specific analytical input from a rating analyst”.

<sup>8</sup> Introduced by Action 1 of the Capital Markets Union new action plan to facilitate investors' access to companies' non-financial data.

## Why do we need to regulate providers of ESG data and services?

### *The lack of transparency on methodologies raises difficulties for users and could entail risks of misallocation and missed opportunity*

- ▶ **ESG ratings are not uniform and can involve different concepts.** Whereas the concept of financial performance and its calculation are now largely embedded in accounting and financial regulation and generally shared by financial market participants, the definition and measurement of non-financial performance are not yet mature and are multifaceted. SSPs adopt different definitions of ESG performance. Indeed, research shows that the correlation between ESG ratings of different providers is quite low, especially when compared to the near 100% correlation of credit ratings<sup>9</sup>. However these differences reflect the different methodological choices made by providers on which concepts to embrace, how to measure these concepts and how to weigh all the underlying indicators in a final score. ESG rating providers can also have different specialisations, where one could be specialised in e.g. labour conditions while another can be specialised in environmental footprint, leading to different weights and degrees of qualities within the analysis. These different concepts and approaches also address the varying client needs and demands. In addition, ESG rating providers' constant reassessments of what ESG performance is, leads to frequent modifications of ESG ratings, which can have major implications for financial institutions.
- ▶ **Given the differences between ESG ratings, transparency on the underlying methodological choices is key.** This level of transparency given by providers of ESG data and services over their methodologies differs and often appears to be insufficient. The stake for investors is threefold: to determine whether a given ESG rating matches their own interpretation of ESG, to assess the quality and robustness of ratings, and to make appropriate investment decisions. This information is also necessary for regulators to be able to monitor the markets. Access to this documentation can prove difficult (e.g. registration procedure, information not public and/or not easy to find). In addition, information on methodologies is sometimes to be found in marketing material. Therefore, defining transparency standards on methodologies should help increase comparability of providers' methodologies while leaving the latter with a large degree of flexibility in designing those methodologies.
- ▶ **A lack of transparency increases the risk of mismatches between the expectations of the investor and actual ESG performance of the investment.** A related risk is that the opaqueness of services such as ESG ratings could be exploited to present a given investment as 'greener' than it actually is (greenwashing). Aside from investor protection risks, ensuing misallocation of investments poses a serious risk to the objectives of the Commission to channel sufficient private investment to the transition towards a climate-neutral economy.
- ▶ **Regardless of the methodological choices, availability and processing of data, data estimation in particular, pose a challenge.** ESG data is not as strictly defined nor as widely available as financial data, and it is common for SSPs to deal with data gaps. Hence, estimation of data plays an important role and the methodology used for such estimations can have a large impact on the

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<sup>9</sup> Florian Berg, Julian Kölbel, Roberto Rigobon, (2020), 'Aggregate Confusion: The Divergence of ESG Ratings'.

final ratings.<sup>10</sup> It is therefore important that providers of ESG data, analysis and services clarify the sources of the information they collect (e.g. use of public information and/or questionnaires sent to companies and/or meetings with rated entities and/or the future European database) as well as the proportion of estimates used and how those estimates have been calculated.

### *The risk of dependence upon a limited number of non-European providers, and potential conflicts of interest*

- ▶ **Growing market concentration could lead to higher levels of proficiency, but also to higher risks of dependence upon a limited number of providers.** Traditional financial players, such as credit rating agencies, benchmark administrators or financial data providers, have entered the ESG data and services market over the past decade. Most ESG data and services providers have since been acquired by more traditional financial players. This wave of consolidation has accelerated in past years, reflecting the increased concentration in the market for financial data and services, as well as the growing importance in financial markets of sustainable finance. This trend constitutes an opportunity to strengthen ESG services resource allocation and testifies to the new role of sustainable investment. It could also lead to a higher level of proficiency and the development of market standards. However, this development also calls for vigilance. In particular, this concentration shift could lead to risks of dependence on a limited number of providers and a less efficient market. Associated risks are: higher prices, barriers to entry, lower competition, reduced innovation and poor coverage of smaller issuers). **Access to SSP services will be crucial for actors who seek sustainable investments; the development of fees and fee structures in this market therefore warrants close attention.**

### What should this regulation look like?

#### Key deliverable

- ✓ A **mandatory regulatory framework at European level** that should take into account the specific features of the ESG data, analysis and services market and should **enable innovation**.
- ✓ Greater transparency on methodologies, and management of conflicts of interest should be the cornerstone of this regulation. However, **regulation should not interfere with the methodologies**.
- ✓ **Specific requirements on internal controls and governance** should be laid down to ensure reliability and quality of the services provided and proper management of potential conflicts of interest.
- ✓ Providers that wish to provide services to European companies should be subject to **authorisation and supervision by ESMA**, and should be **required to operate through an establishment located in the European Union**.
- ✓ The **scope of the regulation** should be well-calibrated to take into account the innovation and the diversity of products offered; articulation with other regulated statuses should be carefully assessed.

<sup>10</sup> For example, missing data for a particular company can be estimated by using data from comparable companies or a market average, but rating agencies can also choose to give a low score for missing data.

- ✓ A **proportionality regime** should be included in the regulation to safeguard innovation and plurality of providers.
- ✓ A **step by step approach**: this regime sets up core requirements for SSPs but should be periodically reviewed taking into account market developments and, where appropriate, complemented by additional measures.

### *A European mandatory regulation is the best option to address the issues identified*

- ▶ The AMF and the AFM assessed different regulatory options, spanning the spectrum from taking no action at all to a compulsory legislative framework at European level. **The AMF and AFM believe that a European mandatory framework, consisting of an ad hoc regulation is the best approach. This option would ensure uniform supervision of the SSPs.** All EU investors and users of ESG data, analysis and services would benefit from the same level of protection, transparency and market integrity. A unified European framework is all the more appropriate since SSPs would operate on a cross-border basis. A proportionality regime could be included for smaller players. The use of an ad hoc regulation would be preferable as opposed to an extension of an existing regulation such as the Credit Rating Agency Regulation<sup>11</sup>, because of the many differences between the provision of credit ratings and the provision of ESG data, analysis and services (see below).
- ▶ **In order to ensure a level playing field and to allow for proper enforcement, the AMF and AFM advocate a mandatory regulatory framework.** While a framework consisting merely of a code of conduct could lead to lower compliance costs, no effective supervision of providers or monitoring of their statements of compliance would be ensured. Based on experience gained with credit rating agencies or proxy advisors, this option would not sufficiently address the identified risks. Similarly an opt-in regime, which would address calls for proportionality, would not ensure harmonisation across Europe and investors would not be provided with the same level of transparency and practices of good governance by all providers. The take-up of such a regime – which is key to the proper functioning of such a framework – would also remain highly uncertain.
- ▶ In the case of a framework consisting of only partially mandatory requirements, for instance solely with regard to transparency, it can be envisaged that no mandatory registration or authorisation by a national competent authority or European Securities and Markets Authority would be required. However, providers located in third countries would then be exempted from any European supervision, creating an uneven playing field and raising the prospect of highly ineffective regulation. **For this reason, AMF and AFM believe a mandatory legislative framework, while allowing for proportionality, is the best approach to addressing the identified risks in the market.**
- ▶ **The creation of a new, ad hoc regulatory framework is preferred to the extension of existing regimes.** ESG ratings are by nature quite different from credit ratings, and SSPs' range of services stretch beyond that of just providing ESG ratings. Indeed, ESG ratings focus not only on ESG risks, but also on ESG performance. The market structure of ESG data and services, as well as risks arising

<sup>11</sup> Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies

from this market structure and the development it is currently undergoing, are different from those of associated markets, such as for credit ratings or benchmarks. The client structure differs as well. It would not be appropriate to fit this into an existing regulation since this could lead to the misapplication of requirements, in this still developing market of SSP services. This should therefore be addressed in a separate regulation.

### *Supervision at European level, by ESMA*

- ▶ **The AMF and AFM are of the view that ESMA should be entrusted with the authorisation and supervision of providers of ESG data, analysis and services.** The authorities believe that this is preferable to regulation by a national authority since providers and clients generally operate on a cross-border basis. Authorisation and supervision by ESMA would guarantee a harmonised application of rules as well as uniform supervision. Besides, ESMA staff would be able to leverage on their experience gained from the supervision of credit ratings agencies and trade repositories. Finally, if ESMA becomes competent for the authorisation and supervision of verifiers of green bonds, as is currently envisaged, it would be consistent that it also regulates providers of ESG data, analysis and services providers.

### *Requiring establishment in the European Union*

- ▶ In order to ensure a sound enforcement of the rules and to ensure that issuers and investors may efficiently interact with SSPs, **the AMF and the AFM believe that the supervisory regime should require SSPs who wish to provide services for European clients to have a permanent establishment in the European Union.** The establishment in the EU is the only way for the European regulator to exert its supervisory powers. The supervisory regime should equally include a requirement for European clients who wish to make use of these services, to use only authorised SSPs, preserving the level playing field. Such an obligation should not constitute a major obstacle since our analysis shows that two thirds of providers operating in the EU already have such an establishment in the EU27<sup>12</sup>.
- ▶ Although Europe is at the forefront in many ESG practices, **the AMF and the AFM propose to design an equivalence and an endorsement regime** within this regulation since it would be a mistake to ignore initiatives emerging on other continents. Although there are currently no other regimes which are comparable, not designing such equivalence could hamper our capacity to innovate in the future.

*The scope of this regulation should be appropriately calibrated in order to take the innovation and the diversity of products offered into account*

**Definition of this regulation's scope demands careful consideration.**

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<sup>12</sup> This analysis was performed on 25 companies including the most influential ones: IHS Markit, MSCI ESG Research, LSEG, Refinitiv, Bloomberg, S&P (Robeco SAM and Trucost), ISS ESG, Sustainalytics, Moody's (Vigeo-Eiris), Arabesque, RepRisk, Qivalio (EthiFinance), Ecovadis and CDP.

- ▶ **The AMF and the AFM are convinced that the scope of this Regulation should be sufficiently broad.** Not only do the AMF and the AFM believe that **limiting the scope to ESG ratings would create a high risk of circumvention**, similar to IOSCO’s observation in its October 2017 report on *Other CRA products* for credit ratings. **The AMF and the AFM are also of the view that the scope should cover the diversity of ESG-related products/services** since risks in the market for SSPs apply not only for ESG rating services, but also for the related services such as the provision of ESG data, scorings, controversies, scenario analysis, taxonomy-related tools, and screenings.
- ▶ **The provision of ESG data needs to be within the scope of this regulation.** Indeed, this data is the very root of all ESG-related analysis and services used by market participants. As it stands, the lack of standardised and reliable non-financial information from issuers makes it very probable that ESG data providers need to apply at least some discretionary modeling to the data. Transparency on the methodologies used and the origination of the data, is therefore essential for these services. Failure to provide transparency and therefore to guarantee the reliability of the services provided would weaken the whole system.
- ▶ **In addition, given that the scope of the regulation could cover a broad range of actors, it is important to make some explicit limits to the scope, including but not limited to :**
  - Only players who operate ‘on a professional and commercial basis’ should be captured (similar to the regulation of proxy advisors);
  - Due to their specific features, external review services on green/social/sustainable bonds or loans should be treated within a separate, specific regulatory framework;
  - The provision of ESG benchmarks should not be part of this regulation as this activity is already regulated under the BMR;
  - The provision of credit ratings should be excluded from this regulation, but be part of the CRA regulation;
- ▶ **Regulated entities that offer sustainability-related products or services should also be subject to this regulation for the provision of those services/products;** as an example, investment firms providing investment research under MiFID should also comply with this regulation; however, they should already meet the majority of organisational requirements since they already comply with equivalent requirements under MiFID.
- ▶ **Lastly, a proportionality regime should be inserted in this regulation.** The economic model of many smaller providers remains fragile and it is important to maintain a diversified offer. Proportionality could be achieved on a case-by-case and exceptional basis, as long as the SSP is able to demonstrate that the requirements are not proportionate in view of the nature and scale of its business. The regulation should not by definition preclude continued access for European market participants to smaller SSPs outside of the EU, for whom a European establishment would be too burdensome. In such cases, a requirement to register with ESMA should still apply, in order to maintain a level playing field and allow for enforcement of the EU rules.

#### **Transparency about methodologies, and conflicts of interest**

- ▶ **Without interfering in methodologies themselves, the AMF and the AFM believe that more granular information** (including information on criteria, selection and weighing factors, metrics



and proxy used) **should be provided in the descriptions of methodologies and models**. In this regard, Annex III of Regulation (EU) 2019/2089 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks could provide a suitable source of inspiration.

- ▶ In addition, the AMF and the AFM believe that **transparency requirements** should cover the following information:
  - **Description** of the products offered and their **characteristics** ;
  - **Main source of raw data** used or marketed;
  - **Processes** in place for collecting data;
  - **How the/an absence of reported data is managed** (no data implemented, absence of data supplemented through: use of peer analysis, data approximation);
  - **Controls in place** to ensure that the data is reliable, verifiable, up to date and comes from reliable sources;
  - Whether providers of ESG data, analysis and services have/hold **dialogues with the companies which are the object of their analysis** and with the stakeholders of the company, and, if so, the extent and nature thereof; such transparency provisions could be inspired by the proxy advisors’ regime introduced by Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (SRD II, Article 3j);
  - Whether or not the providers **rely on particular ESG standards** and whether and how they refer to the **European taxonomy** for some of their products;
  - Frequency and procedure of **revision of the methodologies**; and,
  - Policy in place regarding the prevention and management of potential **conflicts of interest**.

### *Regulation should cover specific requirements in terms of governance and internal control*

- ▶ **Specific attention should be given to the management of existing or potential conflicts of interest.** Although the dominant existing business model is an “investor-paid” one, the concentration process as well as the rapid development of the commercial offer of ESG-related product/services increase the risk of potential conflicts of interest. In addition, the activities of subsidiaries and parents companies should also be taken into account where relevant.
- ▶ Organisational and operational requirements should encompass:
  - **Governance and internal control** requirements;
  - Establishment of an appropriate and effective organisational and administrative arrangements to prevent, identify, eliminate or manage and disclose any **conflicts of interest**;
  - A **review function** responsible for periodical review of its **methodologies**, models and key rating assumptions, and any significant changes or modifications thereto as well as the appropriateness of those methodologies, models and key rating assumptions;
  - Fees: entities should ensure that **fees charged** to their clients for the provision of sustainability-related products/services are **not discriminatory**. Fees charged for

rating services shall not depend on the level of the ESG ratings issued by the providers or on any other result or outcome of the work performed;

- Entities shall put in place processes that allow them to ensure that the **data used is of sufficient quality** and comes from reliable sources; and,
  - An obligation to establish a **right of recourse** for issuers whose data are used for the provision of SSPs' services, in order to offer issuers the right to check, if they so wish, the accuracy of the data used by the provider. In doing so, providers should ensure that the way they implement this obligation does not generate possible situations of conflicts of interest. Sufficient publicity should also be ensured for such interactions; any recourse taken by an issuer and corrective action taken should be made public.
- ▶ Finally, the regulation could also provide for the Commission, in close cooperation with ESMA, to prepare a report on how fees charged evolve over time.
- ▶ **The AMF and AFM consider the above proposal to be a starting point for regulating SSP. A step by step approach is envisioned.** This regime sets up core requirements for SSPs. It should be periodically reviewed taking into account market developments and, where appropriate, complemented by additional measures.