THE INVESTMENT ASSOCIATION

Response to European Commission draft proposals on the regulation of the transparency and integrity of ESG ratings activities

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About the Investment Association

The Investment Association (IA) welcomes the opportunity to respond to the European Commission's proposals on the regulation of the transparency and integrity of Environmental, Social and Governance (ESG) rating activities. The IA champions the UK-based investment management industry, a world-leading industry which helps millions of households save for the future while supporting business and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally. IA members operate from offices across the EU and are active in every single Member state. In 2021/2022, IA members had invested more than £860bn into European equity, and we remain committed to supporting Europe's transition to a greener and more sustainable future. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Executive summary

The IA stands strongly in favour of establishing a regulatory framework for ESG ratings providers and as such we welcome the Commission's objective to enhance the quality of information about ESG ratings, by improving transparency of ESG ratings characteristics and methodologies, and by ensuring increased clarity on operations of ESG rating providers and the prevention of risks of conflict of interest at ESG rating provider level.

A key requirement of sustainable and responsible investment strategies is access to high-quality sustainability data and ratings. ESG data and ratings providers therefore play an essential role, supplying information and services that are material to investment decisions.

The Investment Association

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Recently, we wrote to the UK's HM Treasury to support their proposal to regulate ESG ratings providers outlined in their open consultation on the '[Future regulatory regime for Environmental, Social, and Governance (ESG) ratings providers]'. In our response to that consultation, the IA supported the regulation of ESG ratings providers and articulated many of the messages we make below.

The IA is also a part of the UK Financial Conduct Authority's (FCA) work alongside industry participants to implement IOSCO recommendations by developing a voluntary Code of Conduct for ESG ratings and data providers. We trust that the Code, when finalised, should help fill the gap until such time as ESG ratings, and hopefully data providers, come under the regulatory perimeter of the FCA.

With the escalating demand for sustainable and responsible investment products, there has been an upsurge in the number of data and ratings providers entering the market. This has also led providers to seek to enhance their offerings by acquiring smaller, specialised sustainability-focused service providers. This widespread - and growing - proliferation of such providers, self-regulated initiatives, and market standards has, in turn, led to a number of well-versed challenges, including:

- Overall demand for greater transparency of objectives sought, methodologies adopted, and quality assurance processes put in place by ESG rating and data providers;
- Timeliness, accuracy and reliability of the output from sustainability-related rating and data providers;
- Lack of comparability and bias across sustainability-related ratings, as well as ESG data; and
- Potential for conflicts of interest, particularly associated with providers both evaluating companies and offering paid advisory services to those same companies.

Below, we outline further views on specific elements of the Commission's proposals.

ESG data

We note that the Commission's proposals do not apply to the provision of raw ESG data that does not contain an element of rating or scoring, and is not subject to any modelling or analysis resulting in the development of an ESG rating. However, we do not think that ESG data should be excluded from the scope of regulation. Investment managers appreciate that in the absence of accurate and consistent ESG information from investee companies, many agencies have risen to the challenge of trying to close these data gaps. Whilst useful as a tool to fix the data gaps, the methodologies employed to extract this data often lack consistency and are based on estimates, therefore potentially misleading clients and highlighting a greater need for transparency in methodology for ESG ratings and data.

Capturing ESG data providers, as well as ESG ratings providers, under the regulatory perimeter is the most effective way to address these significant challenges and concerns and to ensure that all aspects of the market for sustainable and responsible investment products are rooted in clarity, transparency and consistency in order to ultimately deliver for end clients.

Furthermore, including ESG data within scope will help to ensure minimal international divergence in the supervision of ESG ratings and data providers by regulators. The inclusion of ESG data within scope is in line with the IOSCO recommendations, which have in turn been followed by other jurisdictions. Creating different models and requirements will result in different due diligence requirements by asset managers which will prove costly and inefficient.

Given the difficulties in distinguishing between data providers that are just providing reported data and those that are also providing estimated data, we strongly believe that all data created, curated or derived by or within providers and sold as a product should be in scope. Several types of ESG data may seem like raw/reported data but actually embed assessment or value judgement. Even for raw/reported data, there should be a minimum quality standard.

Harmonisation of corporate reporting standards

It is important to acknowledge the role played by the harmonisation of corporate reporting standards for sustainability in addressing the unreliability of marketed external ratings and data products. To that end, we welcome the work of the ISSB in developing global sustainability standards for corporate disclosures. We also support the UK Government's timeline and process for implementing the ISSB standards and we will work with stakeholders to ensure their swift adoption in the UK. Furthermore, we urge other jurisdictions to endorse these standards and incorporate them into their reporting requirements.

However, until we secure globally harmonised and secure ESG data from corporates, we emphasise the need for regulators across the globe to collaborate to develop consistent frameworks for the regulation and supervision of ESG ratings and data product providers. We are grateful that the need for a global approach and collaboration on this matter is clearly recognised by IOSCO in its November 2021 Final Report on ESG Ratings and Data Products Providers. In this report, IOSCO recommends that many of the issues and concerns around the use of and reliance on third-party ESG data and rating product providers should be addressed by collaboration between global regulators.

This will help to drive more alignment and consistency between data and ESG ratings products globally and will reduce the barriers to entry faced by new data products and ratings providers, which should in turn lead to more competitive pricing of the products produced by this sector. It will also support those providers that operate cross border and in multiple jurisdictions by providing consistency in regulatory expectations and requirements.

Definition of 'ESG rating'

In order to ensure consistency in global standards, the description of an ESG rating in the Commission's proposals should be consistent with international descriptions, most notably that of IOSCO. Therefore, the IA proposals the definition should be as follows:

"ESG ratings": refer to the broad spectrum of ratings products that are marketed on a commercial basis (i.e. for a charge) 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, whether or not these are explicitly labelled as "ESG ratings".

Furthermore, considering IOSCO's Report asks for tackling both ESG data providers as well as ESG rating providers in the case of data or ratings which are marketed by those providers, it is crucial to secure the same scope of application for the EU. It would secure the reliability of ESG data and ratings provided to asset managers, and therefore their meaningful use by our members to the benefit of EU investors.

Treatment of proprietary ratings

We support the following exclusions from the scope of the legislation: '*private ESG ratings which are not intended for public disclosure or for distribution and ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in-house financial services and products'*. However, we are concerned that such assessments could be caught under the regulation once they are made public, for example, where members make disclosures in line with the Sustainable Finance Disclosure Regulation (SFDR).

Our firm position is that only where an entity is disclosing individual proprietary entity ratings publicly and systematically on a commercial basis, for a charge, should they be in scope of the regulation, not where a rating is used as part of the fund marketing. Investment firms are already regulated entities, and investment products are also subject to extensive regulation.

Ratings or data are not the product in itself, but a means to achieving a desired investment outcome. In this sense, they are similar to proprietary credit ratings or internal stock ratings that firms utilise for portfolio construction purposes, and they do not need to be regulated. Proprietary ESG ratings used for product purposes should be treated in the same way as those ratings utilised in mainstream investment products, irrespective of whether they are disclosed to clients, at product level or not disclosed at all.

Proportionality

We note that under Article 20 on governance requirements, the Commission states that ESMA may exempt an ESG rating provider at its request from complying with some of the requirements laid down in Article 14 where that ESG rating provider is able to demonstrate that those requirements are not proportionate in view of the nature, scale and complexity of its business and the nature and range of the issuance of ESG ratings.

The IA's view is that any regulatory framework for this market should take a proportionate approach based on the size of the firm and should also allow flexibility to change in the future as the market grows. Onerous regulatory requirements could have implications for smaller more specialist providers and could stifle start-ups/innovation and become a barrier to entry.

We hope you will find the above views helpful. The IA welcomes continued discussion with the Commission and relevant stakeholders on the regulation of ESG ratings and data providers.