

POSITION PAPER

EU REGULATION ON ESG RATINGS

January 2024

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To inform this paper, the following investor group has been consulted: PRI Global Policy Reference Group. This consultation is not an endorsement or acknowledgement of the views expressed in this paper.

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United Nations
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ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has now over 5,000 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles, representing US \$121 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

ABOUT THIS POSITION PAPER

This paper focuses on the EU legislative proposal to regulate ESG rating providers, as discussed in trilogues in January 2024.

The PRI welcomes the European Commission's [proposal](#) to regulate ESG ratings and the providers of these products and to make these entities subject to authorisation and supervision by ESMA. The proposed rules will increase transparency on the methodologies of ESG ratings, enabling investors to better compare and understand these products. The proposed governance requirements will help to ensure ESG ratings are independent and devoid of conflicts of interest, which will foster trust and confidence in this growing market.

This paper aims to outline policy recommendations to improve the draft regulation and ensure greater reliability and integrity for investors, during trilogues starting in January 2024. It focuses on four key issues: scope of the regulation for data product providers and non-profit civil society; transparency requirements and conflict of interest. While the treatment of third-country providers and especially the regime for them to be allowed to offer ESG ratings in the EU will also be a sticking point for trilogues, PRI does not have specific position on that issue.

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INTRODUCTION

Over the past few years, the growth of responsible investment practices has led to a steep increase in demand for ESG information. Many investors rely on corporate reporting, complemented by ESG data and ratings products, to assess portfolio performance and inform voting decisions and engagement practices.

The PRI notes that ESG ratings products based on clear objectives, transparent methodologies and reliable ESG data can enable investors to make better informed decisions and incentivise sustainable investments. However, it is PRI's view that the transparency and integrity of the ESG ratings products market should be improved. PRI has engaged on this topic by responding to consultations from IOSCO ([September 2021](#)) and the European Commission ([June 2022](#)), and [commenting](#) on the EU sustainable finance package published in June 2023. In our various communications, we reiterated the need to:

- Improve transparency of both ESG data and ratings product providers on their methodologies and data processes, by developing minimum quality and transparency standards.
- Ensure that ESG data and ratings product providers have appropriate governance arrangements in place that prevent conflicts of interest and ensure the independence and integrity of their research and offering.

In this respect, the PRI welcomes the European Commission's proposal to regulate ESG ratings and the providers of these products which goes in the right direction to increase transparency and integrity in the ESG ratings market. The proposal has already been welcomed by important market players such as Future of Sustainable Data Alliance (FoSDA)¹. The PRI also welcomes the Parliament's final position² on the file and its willingness to clarify transparency requirements and strengthen the conflict-of-interest provisions. PRI also welcomes the Council's General Approach³ which clarifies the scope of the regulation for EU and non-EU providers of ESG ratings.

With trilogues planned to start in early January 2024, the PRI would like to share some recommendations to improve the draft regulation and ensure greater reliability and integrity for investors. This includes broadening the scope of the regulation to include ESG data product providers, ensuring that transparency requirements lead to comparable and more generally decision-useful data for investors⁴, and tackling conflicts of interest more effectively.

The PRI's position on this file seeks to find a balance between the user perspective (investors) – who rely on both ESG ratings and data providers for their investment decisions and reporting activities– as well as the ESG information provider perspective, still seen as a relatively nascent industry, in the process of adapting its business model and products to evolving corporate disclosure obligations under the Corporate Sustainability Reporting Directive (CSRD) (and accompanying European Sustainability Reporting Standards - ESRS) and the Taxonomy regulation.

Therefore, in addition to our recommendations on ESG ratings, the PRI recommends accelerating the reforms towards mandating corporate reporting standards and disclosures of key underlying ESG data. These efforts are crucial to increase the availability and quality of ESG data, and by extension the quality of ESG ratings and data products, as both investors and providers need decision-useful corporate disclosure. We welcome extensive efforts by the European Commission and EFRAG in finalising the first set of ESRS – which will greatly improve the decision-usefulness of corporate ESG disclosures across many sustainability issues, while ensuring interoperability with international standards. Although largely limited to EU-based issuers, we see these developments as complementary and additional to the goal and scope of the ESG ratings regulation to improve the functioning of the ESG information market.

¹ FoSDA Position Paper on ESG ratings, scores and data products policy initiatives, October 2023

² [Draft European Parliament legislative Resolution, 8.12.2023](#)

³ [EU Council General Approach, 15.12.2023](#)

⁴ As set out in the PRI's [Investor Data Needs framework](#), to be decision-useful, sustainability information must be accessible, verifiable, comparable across multiple dimensions, a faithful representation and relevant to investors. Although this definition was designed for (raw) data from corporate reporting, it is also applicable to other data channels like products from data providers.

RECOMMENDATIONS ON ESG RATINGS PROPOSAL

1) INCLUDE ESG DATA PRODUCT PROVIDERS IN THE SCOPE OF THE REGULATION.

ESG ratings and data products providers have become important components of the responsible investment chain. According to ESMA's 2022 call for evidence⁵, investors tend to use both ESG ratings and data products in their decision-making and activities. Out of 66 respondents, only 4 indicated that they only used ESG ratings. However, investors have noted that both ESG ratings and data products providers' methodologies are sometimes not sufficiently transparent and verifiable. This is applicable whether the underlying data is estimated or taken from companies. Transparency and verifiability of such methodologies must be improved to enable investors to fully assess ESG information products during their due diligence processes.

Moreover, ESMA's findings highlight the close relationship between ESG ratings providers and those of ESG data products. 73% of ESG ratings providers who responded to ESMA's survey stated that they also offer ESG data products. In line with IOSCO's recommendations, the PRI notes that governance requirements such as those aimed at preventing conflicts of interest should apply to providers at the entity level and, as such, to data providers who are also ratings product providers.

In light of the above, the PRI considers that both ESG ratings and data products providers should be included in the scope of the regulation. Broadening the scope of the regulation is consistent with both IOSCO⁶ and ESMA's recommendations and would help drive more transparency and integrity in this market. The PRI therefore encourages clarifying the position of the Council in Article. 2⁷ by indicating clearly that ESG data providers should also be included in the scope.

An expansion of the scope could take several forms. We detail below some pros and cons associated to two options:

- **Option 1: include ESG data product providers in the regulation** from the start but subject them to a limited number of transparency requirements, e.g., the disclosure of an overview of data methodologies, data processes (data sources), information on the use of estimation, policies for updating data and revising historical data, date of last updates of data, and data quality controls.
- **Strengths:** by providing more lenient requirements for ESG data product providers, the regulation would remain proportionate and allow for innovation in the ESG information market. Also, a number of ESG information products sit somewhere on the continuum between data products and ratings products. By including all ESG data product providers in the scope, the regulation will recognise the diversity of ESG information products for end users and therefore clarify the scope of products being regulated.
- **Weaknesses:** broadening the scope of the regulation has not been accounted for in the European Commission's impact assessment. This could lead to operational difficulties and delays in the implementation of the regulation, as ESMA would need to authorise an increasing number of organisations. Moreover, the proposed regulation is tailored to ESG ratings and was not crafted with ESG data products' business model in mind. Those that will now be brought into scope (i.e. data providers without any ratings products) may face additional burden while this market segment is focusing efforts on adapting their offerings to EU initiatives such as CSRD and ESRS.

⁵ [Outcome of ESMA Call for Evidence on Market Characteristics of ESG Rating and Data Providers in the EU, June 2022](#)

⁶ [IOSCO calls for oversight of ESG Ratings and Data Product Providers, November 2021](#)

⁷ Article 2 of the Council proposal – "This Regulation does not apply to the publication or distribution of data on environmental, social and human rights, and governance factors that do not result in the development of an ESG rating";

- **Option 2: include a review clause**, as proposed by the Parliament (Recital 15-c), to consider bringing ESG data products providers into the scope of the legislation three years after the date of entry into force, based on the result of an impact assessment of the regulation conducted by the Commission.
 - **Strengths:** a review clause will allow ESG data products providers to adapt their processes and products to EU initiatives such as the CSRD and ESRS and be more prepared to integrate the ESG ratings regulation's requirement in due time. It will also give the European Commission more time to conduct a thorough impact assessment on a possible scope extension.
 - **Weaknesses:** a review clause three years after the actual date of implementation would mean at least ten years from now without any legal responsibility for ESG data product providers in the EU. It is therefore an imperative to at least have a review clause.

The PRI has a slight preference for Option 1. If option 2 (introducing a review clause) is retained, the PRI encourages the European Commission to ensure global alignment in data products' practices and drive further transparency across markets in the meantime. This could take the shape of an industry code of conduct for EU ESG data products providers, aligned with other codes already developed by regulators, especially [ICMA](#) global voluntary Code of Conduct for ESG ratings and data products providers.

In addition, it is PRI's view that the current scope of the regulation could better account for the diversity of ESG ratings products available in the market, as detailed in the Council's position (Article 2). For example, some financial institutions have developed internal scores that they provide to clients for free, in the interest of transparency. We consider that such tools should not fall into the scope of the regulation. In order to better reflect the market's reality, more nuances should be brought to the list of ESG information products that are not covered by the regulation. PRI also supports the Council's proposal to have a three-year temporary regime for small ESG rating providers (Article 4a).

2) EXCLUDE FROM THE SCOPE OF THE REGULATION NON-PROFIT CIVIL SOCIETY ORGANISATIONS THAT COMPILE SCOREBOARDS OR RANKINGS FOR NON-COMMERCIAL PURPOSES AND THAT MAKE THOSE TOOLS ACCESSIBLE FREE OF CHARGE.

It is PRI's view that civil society organisations that offer tools – such as scoreboards or rankings – for non-commercial purposes should not be subjected to the same level of regulatory requirements as ESG information providers who receive the majority of their financing from the sale of their services.

3) ENSURE THAT TRANSPARENCY REQUIREMENTS FOR ESG INFORMATION PROVIDERS LEAD TO DECISION-USEFUL DATA FOR INVESTORS.

The PRI acknowledges that investors have the responsibility to understand the intended purpose and the methodology of ESG ratings and data products, and to determine whether these are suitable for their investment strategies. We welcome the Commission's principle of non-interference with ESG rating methodologies, and ensuring that European investors have access to granular overview of ratings' methodologies and data processes. Appropriate disclosure requirements on methodologies are essential to enable investors to make better informed investment decisions while protecting ESG information providers' intellectual property rights.

Ensuring transparency of ESG ratings' objective is particularly important. Indeed, ESG ratings can assess different sustainability aspects, from focusing solely on financial materiality to measuring sustainability performance of rated entities. The PRI considers that ESG ratings providers should communicate more clearly to investors whether their ratings focus only on financial materiality, sustainability performance, or

both. To do so, we support the need for ESG ratings providers to display clear disclaimer on their ratings' objective and the conclusions that can be drawn from them.

The PRI supports the Parliament's proposal to strengthen other transparency requirements on methodologies (Annexe III – Disclosure requirements). This includes the need to clearly communicate on the time horizon covered in a rating, whether the data initially provided by the issuers has been subject to an assurance review and the need to provide warnings about the limitations of the methodology used (e.g., if it is based on relative values or does not consider scientific evidence). The PRI also considers that the way ESG information providers engage with companies and how those companies can provide feedback on their ratings should be made transparent as part of their methodology disclosure. We believe that these additional requirements will not only help investors, but also make ESG ratings and data products providers more accountable for how they verify and validate their data sources and metrics.

The PRI also welcomes the Commission's proposed transparency requirement regarding fees charged by providers. Clear fee structures can benefit investors, and other users of ESG information products, as it enables them to understand what they are paying for, and it makes it easier for them to compare the prices of different products as well as anticipate and budget any increase in ESG information product costs on a clear basis. Given the recent market consolidation in the ESG information sector, the PRI supports the Parliament's proposal to provide general information to the public on criteria used for establishing fees to clients (Article 22 and Annexe III).

4) STRENGTHEN CONFLICT OF INTEREST PROVISIONS.

ESG information providers should have appropriate governance arrangements in place so that products and services on offer are free of conflicts of interest or other undue influences. We support the Parliament's proposed measures to prevent conflict of interest (Article 23). It is important that these measures are taken by all ESG ratings companies that may set different business units to clearly separate activities such as ESG ratings products services and other services such as consulting or audit activities to investors.

It is also PRI's view that ESG ratings providers should be authorised but not required to provide their draft research/ratings for review by the entities they are rating and who have a clear self-interest in ESG rating outcomes. Requiring ESG ratings providers to provide their draft research/ratings is in direct conflict with the regulation's prioritisation of independence and non-interference principles, as well as the proposed extensive measures designed to instil and protect analyst and provider independence. Similarly, we underline that the complaints-handling mechanism should be balanced against these very objectives, safeguarding the independence of providers and their methodologies as much as possible.