Proposed EU Regulation on the transparency and integrity of ESG rating activities

Afep position

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Context

Large French companies welcome the proposal for a regulation on the transparency and integrity of ESG rating activities presented by the EU Commission. Afep members have been calling for a mandatory European legal framework for the past years, to allow for a rapid improvement of practices, increased transparency, and a better dialogue between ESG rating agencies and companies.

Considering the **growing importance of ESG data and ratings in the decision-making process of investors and companies**, and at the same time the **uncertainty and confusion** about the precise meaning of ESG ratings due to **lacking transparency on underlying methodological choices**, the introduction of stringent obligations for all ESG rating providers is necessary to ultimately increase the overall confidence between all actors in the market.

Key messages

While companies welcome the Commission's proposal, they are calling for a more ambitious text allowing to address a larger scope of concerns and difficulties encountered by companies relating to ESG ratings. Afep therefore proposes to introduce the following additional points :

- **include processed ESG data** in the scope in addition to ESG ratings;
- **make non-EU rating providers subject to obligations which are as stringent as those applying to EU rating providers;**
- **guarantee rated entities a right of reply prior to and after the publication of the ESG rating;**
- **entrust ESMA with a supervisory role over the complaints handling mechanisms and introducing a right of appeal;**
- **strengthen transparency obligations to the public** on rating methodologies, sector classifications, fee structures and pricing criteria;
- **strengthen transparency obligations to the rated entities** on methodologies specifically applied to them, the use of artificial intelligence in the data collection and rating process, and the handling of controversies;
- **allow companies to communicate freely and at no extra cost on their rating and that of their peer group.**

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Detailed comments

1. Scope of the Regulation (article 2)

- Processed ESG data should be included in the regulation

ESG data is key for financial market participants to allocate capital towards sustainable activities and to meet their regulatory requirements. ESG data, both raw and processed, is the foundation on which the entire sustainable finance action plan is built. **If the data lacks reliability and comparability, companies fail to see how it can be used for ratings purposes**.

Companies understand that the provision of raw ESG data is not included in the scope because other texts such as CSRD (Corporate Sustainability Reporting Directive) have addressed the disclosure of raw ESG data by companies. In the EU, the companies falling under the scope of CSRD, will indeed have to provide high-quality, comparable, reliable, audited raw ESG data. However, there are **ESG products providers who process this raw ESG data** disclosed by companies to aggregate or process it or make it subject to **modelling or analysis** in order to sell it for example to ESG rating agencies or respond to investor needs who use such processed data for their proprietary methodologies. **This process is not sufficiently transparent**, and it is difficult for companies to check the reliability of processed ESG data concerning their activities.

Companies observe that **ESG data providers often lack solid internal control systems** which impairs the provided data's reliability. Such data may be subject to estimates and proxies, and there may be errors such as inappropriate changes in measurement units.

The provision of processed ESG data should therefore also be subject to governance and transparency requirements to ensure data integrity and reliability. This would also help fight against greenwashing risk.

At the very least, a **review clause** should imperatively be added, allowing to speedily extend the scope of the Regulation after its entry into force.

- The exclusion of ratings produced by financial institutions for "internal purposes" should be clarified

The difference between ESG ratings produced by regulated financial undertakings "for internal purposes" and "private ESG ratings not intended for public disclosure or for distribution" is not entirely clear and should be clarified. Also, ratings provided by subsidiaries belonging to the same group of regulated financial undertakings should be excluded.

2. Definitions (article 3)

- The definition of "score" should include also literal or other forms of measure

There is a lack of precision in the definition of "score". Etymologically a "score" implies a numerical result, which would exclude results in the form of letters and others which are nevertheless increasingly used by ESG rating providers (see the Carbon footprint score from Moody's ESG Solutions or the Low Carbon Transition Rating from Sustainalytics).

It is therefore necessary to clarify this terminology in order to ensure that a "score", is defined as "a measure derived from data, obtained using a rules-based method, and based only on a pre-established statistical or algorithmic system or model, without any additional substantial analytical input from an analyst, **regardless of whether it is presented in numerical, literal or other form**";

- ESG ratings / data providers should be in the scope irrespective of whether they publicly disclose or distribute on a commercial basis or not

The definition of "ESG rating providers" refers to the offering and distribution of ESG ratings or scores "on a professional basis". A clarification would be welcome to confirm our interpretation of the text which is that **NGOs, charities, or other non-profit providers of ESG ratings/data are included in the scope of the Regulation**. Their scores, rankings etc. can have a considerable impact on investors, public opinions, regulators, and public authorities. It is therefore necessary to make them subject to the same requirements of transparency, governance, independence as for-profit organisations **regardless of their legal form and whether they operate on a for-profit basis or not**.

3. Third country ESG rating providers (articles 9 to 12)

- The obligations for non-EU providers should be as stringent as for EU providers

Under the proposed endorsement and recognition regimes, the compliance with IOSCO recommendations is considered sufficient to comply with the proposed EU Regulation. Although IOSCO recommendations are a welcome step in the right direction, they are much less detailed than the requirements laid down in the draft regulation. **Putting the less stringent IOSCO recommendations on an equal footing with the EU regulation would create an uneven level playing field for EU providers**, ultimately hindering the emergence of EU players.

4. Engagement with rated entities (new article)

- Introduction of a right of reply prior to the publication of the ESG rating

ESG rating providers need to engage with the rated entity before publication of the rating to **ensure that the rated entity is informed that it will be rated** and that it will have a **right to respond** to the draft rating **within a reasonable timeframe**.

Afep proposes to introduce the obligation for the ESG rating providers to send any analysis impacting the entity's scoring **at least one month before its publication**. ESG rating providers should grant a **"right of reply"** to rated entities during that month. ESG rating providers should be obliged to justify whether the feedback from the rated entity has been accepted and, if not, why.

- Introduction of a right of reply after the publication of the ESG rating

If the ESG rating provider has not taken into account the companies' feedback regarding it rating, the applied methodology, potential errors, inadequate sector classification or use of controversies, **the rated company should be entitled to request the ESG rating provider to make public, together with the rating, the company's comments** on inaccurate or irrelevant data or inappropriate methodologies ("**company quote**").

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5. Complaints-handling mechanism (article 18)

- ESMA should be entrusted with the establishment, operation and supervision of the complaints-handling mechanism

While the introduction of such a mechanism is welcome, it does raise a number of questions, including that of the appropriate platform. To date, many agencies have made it possible to express a complaint or share a comment, but these platforms remain inefficient or ineffective either due to a malfunctioning platform or the lack of response.

This is why **ESMA should be entrusted with the establishment, operation and supervision of a feedback mechanism** allowing rated entities to introduce their complaints regarding the different ESG rating providers. In addition, the current formulation of article 18 § 2b is too vague. The complaint procedure should introduce a **specific deadline for ESG rating providers to communicate the outcome of their investigation, e.g., within one month**.

The smooth functioning of this mechanism is essential considering the consequences of an inaccurate rating on the company's financial situation and reputation.

- ESMA should be entrusted with the handling of appeals

Within the complaints handling mechanism placed under the supervision of ESMA, there should be a **right of appeal in case of disagreement between the ESG rating provider and the rated entity or a lack of response to a complaint.** ESMA should be responsible for deciding on such appeals against decisions or communications by ESG rating providers or the lack of such decisions or communications.

Indeed, when rated entities submit complaints about incorrect data, inappropriate handling of outdated or anecdotal controversies as well as inadequate methodologies which do not take into account their sector specificities, it frequently happens that these complaints remain without response from the ESG rating provider or that the responses are drafted in boilerplate language which shows that no real investigation has been conducted.

6. Disclosure requirements

- Enhanced disclosure requirements to the public (annex III point 1)

On the weighting of considered indicators

Annex III point 1 f) requires ESG rating providers to publicly disclose the weighting of the three overarching ESG factors categories (e.g., 33% Environment, 33% Social, 33% Governance) and the explanation of the weighting method, including weight per individual E, S and G factors. **This is not sufficient as it only concerns the highest level of weighting but does not give the necessary transparency on the weighting of the specific indicators that are taken into account for the rating**.

Without this information, it is impossible for the public to understand the nature of the rating. For example, the overall category of social factors can prioritize diversity, health & safety of employees or working conditions on supply chains. Depending on the weight of each of these indicators, the final rating for the category “S” will not be the same at all.

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On sector classification (new disclosure item)

The proposed public disclosure requirements ignore an essential aspect: the sector, i.e., the selection of companies against which a rating will make sense to stakeholders, and in particular investors. To date, there is no common sector classification used by all ESG rating providers regarding rated entities and **companies are confronted with important divergences between rating agencies regarding the classification of sectors and sub-sectors**.

Some agencies use their own sector classification methodology, which is completely different from that of the other agencies. **Depending on how rated companies are sectorised, they find themselves in the same group as companies that don't have the same ESG risks or impacts.** This can lead to significant differences, which are not necessarily made explicit in the final rating.

For example, a food service company may be included either in "Food & Beverages" or in "Hotels & Leisure". Likewise, a manufacturer of personal care products may be included in "Luxury Goods & Cosmetics", "Personal products" or "Consumer products". The ESG issues will be entirely different, because the company in sub-sector A will be rated on a different grid (number of criteria & weighting) from that in sub-sector B. Likewise, the peer group of competitors with whom the company is compared will not be the same.

It is therefore essential that ESG rating providers are more transparent in terms of sector qualification and, above all, that they grant companies the opportunity to discuss this precise point before being rated. They should describe the adjustments they make to compare ratings between different sectors. The regulation should ensure that such methodological distinctions are visible and explained in the sector report and also on the profiles/scorecards of each company. Ideally, the **choice of sector classification should be made in coordination with the rated company** as the sector classification can have a significant impact on the methodology applied, and therefore on the final rating.

Regarding fee structure and pricing criteria (new disclosure item)

The level of ESG data costs, which is constantly rising, merits particular attention from the authorities. Without a reasonable cost, it will not be possible to develop a market for attractive European ESG financial products, which is key to meeting the huge needs required to finance the transition.

Article 25 requires ESG rating providers to "take steps that are adequate to **ensure that fees charged to clients are fair, reasonable, transparent, non-discriminatory and are based on costs**". Annex III lists minimum disclosures to the public, including "general information" on criteria used for establishing fees to clients. **The disclosure of such "general information" is not sufficient** to ensure that the obligation of article 25 is applied.

Therefore, the **fee structure and pricing criteria should be publicly disclosed, as well as information on revenue divided into fees from ESG rating and other ancillary services with a comprehensive description of each**. This information should also be reported to ESMA, whose power must be strengthened to ensure that application.

- Enhanced disclosure requirements to rated entities (annex III point 2)

On the rating process

Annex III point 2 c) requires the ESG rating providers to make available, "where applicable, information about engagement with rated entities". This is insufficient. All ESG rating providers should provide rated entities with **a clear and formal notice regarding the rating process** including the following **:**

- a contact point in charge of the rated entity;
- the period during which questionnaires, if any, are being sent out;
- the procedure allowing the rated entity to correct errors;
- the description of the timing and precise terms of the rating process;

On the rating methodologies

The "more granular overview of the rating methodologies used and of data processes", mentioned in Annex III point 2 a) and b) are not sufficient and should also include a **comprehensive methodological documentation** precisely defining the terms, and explaining how data points are to be answered.

In addition, a **more granular overview specifically adapted to the rated entity** should include the following information:

- whether the selected data point is used for the ESG rating and/or for another product ;
- the source of the data point ;
- the date of the last update of the data point ;
- whether the rating provider uses the data points and definitions contained in the **European Sustainability Reporting Standards** (ESRS) for their ratings.
- an explanation about how the data point is evaluated and how this evaluation impacts the final rating, allowing the rated entity to recalculate its score by itself.

On the use of AI methodologies used in the data collection or rating process

It is essential for the rated companies to have a complete overview of the use of AI by the agencies, which is not guaranteed in the proposed text. Annex III point 2 d) only requires the ESG rating providers to make available "where applicable, an explanation of any AI methodology used in the data collection or rating process". This is insufficient as the increasing use of artificial intelligence by the agencies poses a number of risks for the agencies themselves, but above all for the companies being assessed.

ESG rating providers should be required to disclose the **type of technology as well as its date and place of use.** These details will make it possible to detect errors and/ or any external influences on the rating of companies particularly in the event of geopolitical conflicts.

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On controversies

Companies need to fully understand the **precise methodology applied to any controversies to which the rated entity may have been subject**. The proposal does not address the issue of controversies, even though this is an essential point given their significant weight in the final scores and the reputational impact on the entity concerned. The list of transparency elements required of agencies should therefore include:

- the **procedure for selecting sources** from which controversies may originate;
- the **criteria used to assess the reliability and credibility of the source**;
- the **methodology for assessing the degree of severity of the controversy** and its impact on the final ESG score, including:
    - the **criteria** used (e.g. quality of the source, media impact, existence of a court ruling, number of people impacted in relation to the size of the company, etc.);
    - the **scales** used (e.g. impact deemed severe if there are more than x strikers involved in a social movement, impact deemed severe if the company does not respond within x days);
    - **weightings** for each criterion;
- the **procedure for collecting, analysing and integrating into the report and rating** the following points:
    - the company's right of reply;
    - corrective action taken by the company;
    - new information relating to the controversy;
- the **procedure for dealing with appeals** lodged by companies with the rating agency regarding the handling of a controversy.

In addition to these transparency obligations, ESG rating providers should be obliged to:

- **inform the company of any new controversy added to the rating** within a reasonable timeframe, so that the company can respond as soon as the controversy arises and the ESG rating provers modifies the report.
- **include in the report**, **for each controversy all the sources**; the company's **response**; information on any **legal proceedings** underway or closed in relation to the controversy, and to indicate the **absence of legal proceedings** where applicable; **the date on which the information was last updated**.

- Introduction of a right for companies to communicate freely and at no extra cost on their rating and that of their peer group (new article)

Companies should be allowed to communicate freely and at no extra cost on their rating and that of their peer group. Indeed, without any element of comparison, the rating loses significantly in value. Also, ESG ratings have become an essential tool for promoting a company's CSR approach to external stakeholders, starting with investors.

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About AFEP

Since 1982, AFEP brings together large companies operating in France. The Association, based in Paris and Brussels, aims to foster a business-friendly environment and to present the company members' vision to French public authorities, European institutions and international organisations. Restoring business competitiveness to achieve growth and sustainable employment in Europe and tackle the challenges of globalisation is AFEP's core priority. AFEP has around 117 members. More than 8 million people are employed by AFEP companies and their annual combined turnover amounts to €2,600 billion.

AFEP is involved in drafting cross-sectoral legislation, at French and European level, in the following areas: economy, taxation, company law and corporate governance, corporate finance and financial markets, competition, intellectual property and consumer affairs, labour law and social protection, environment and energy, corporate social responsibility and trade.

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