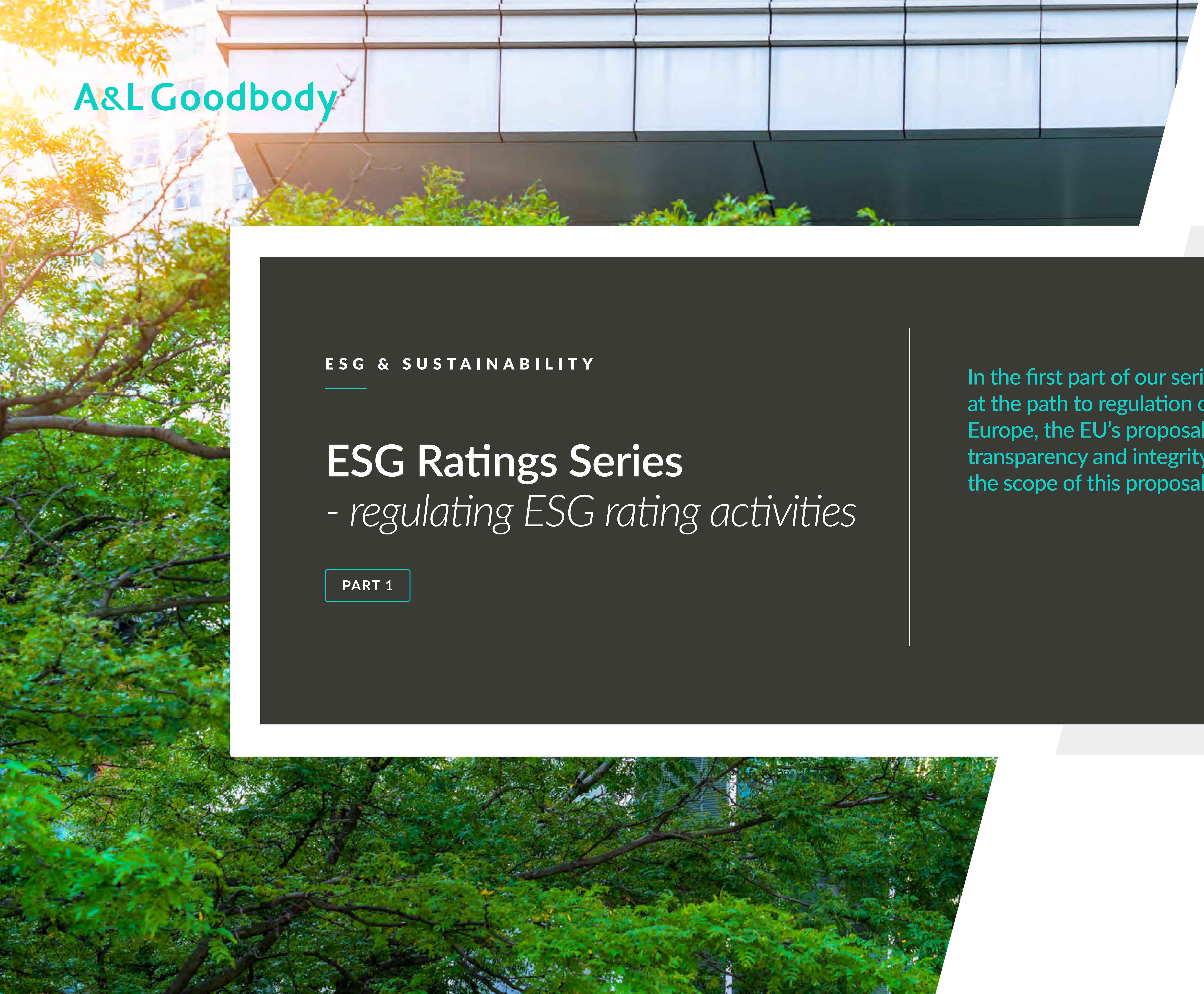


A&L Goodbody

ESG & SUSTAINABILITY

ESG Ratings Series
- regulating ESG rating activities

PART 1

In the first part of our series on ESG ratings, we look at the path to regulation of ESG rating activities in Europe, the EU's proposal for a regulation on the transparency and integrity of ESG rating activities and the scope of this proposal.

6 MIN READ

The role being played in the global capital markets by environmental, social and governance (**ESG**) ratings has become increasingly important in recent years.

The continued growth in use of ESG ratings by investors, borrowers and issuers as part of their sustainable investment and financing decision making processes means that ESG ratings can have a significant influence on the operation of these markets.

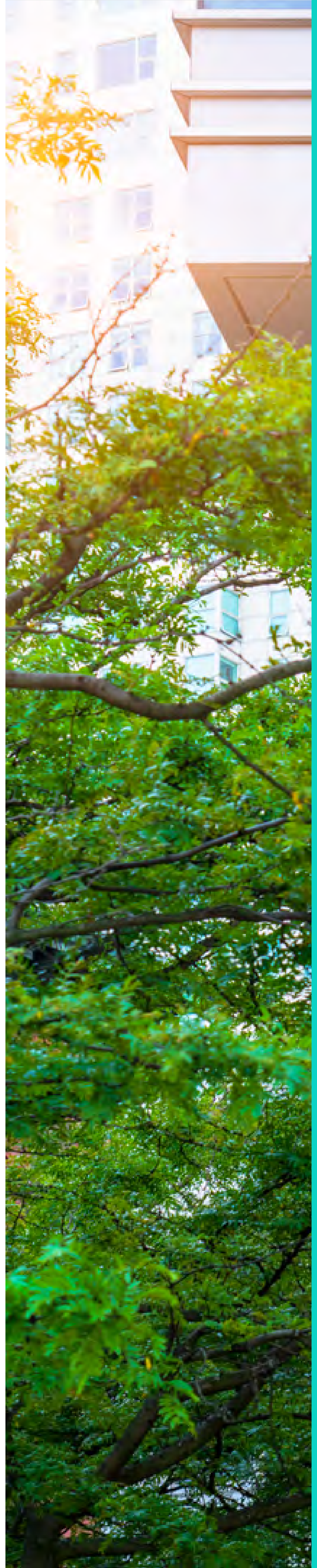
As such, there has been increased focus by regulators and policy makers on both the ratings themselves and their providers. ESG rating providers are not currently subject to authorisation or supervision in the EU. In the absence of a regulatory framework, several issues started to emerge. These primarily related to the lack of transparency and accuracy of ESG ratings methodologies, the existence of conflicts of interest and green washing concerns.

In November 2021 following a public consultation, the International Organization of Securities Commissions (**IOSCO**) published a final report on ESG ratings and data product providers. This report identified shortcomings with ESG ratings and set out 10 specific recommendations for improving the provision of ESG ratings. These recommendations included promoting transparency and managing conflicts of interests.

A European Commission commissioned study titled "sustainability related ratings, data and research" published in 2021 highlighted the existence of conflicts of interest, the lack of transparency and accuracy of ESG ratings methodologies and the lack of clarity over the terminology and the operations of ESG rating providers.

The European Commission carried out a public consultation on ESG ratings in 2022, where stakeholders voiced concerns on the lack of transparency of ESG ratings methodologies and objectives and sought clarity over ESG rating activities.

The progress report on greenwashing published by the European Securities and Markets Authority (**ESMA**) in 2023 cited ESG ratings as being a major channel of transmission for misleading sustainability related claims and called for regulation in the industry.



Introduction of the ESG ratings regulation

Against this backdrop and in response to calls for regulation, the European Commission published a proposal for a regulation on the transparency and integrity of ESG rating activities on 13 March 2023 as part of a package of measures related to the sustainable finance framework.

On 5 February 2024, the European Parliament and Council reached a provisional political agreement on the text of the Regulation on the transparency and integrity of ESG rating activities (the **Regulation**). At a plenary session on 24 April 2024, the European Parliament adopted the Regulation, with final sign-off from the Council of the EU required before the final version is published in the Official Journal of the EU.

The Regulation is intended to enhance the transparency and independence of ESG rating activities, increase consumer and investor protection and to prevent greenwashing or other types of misinformation.

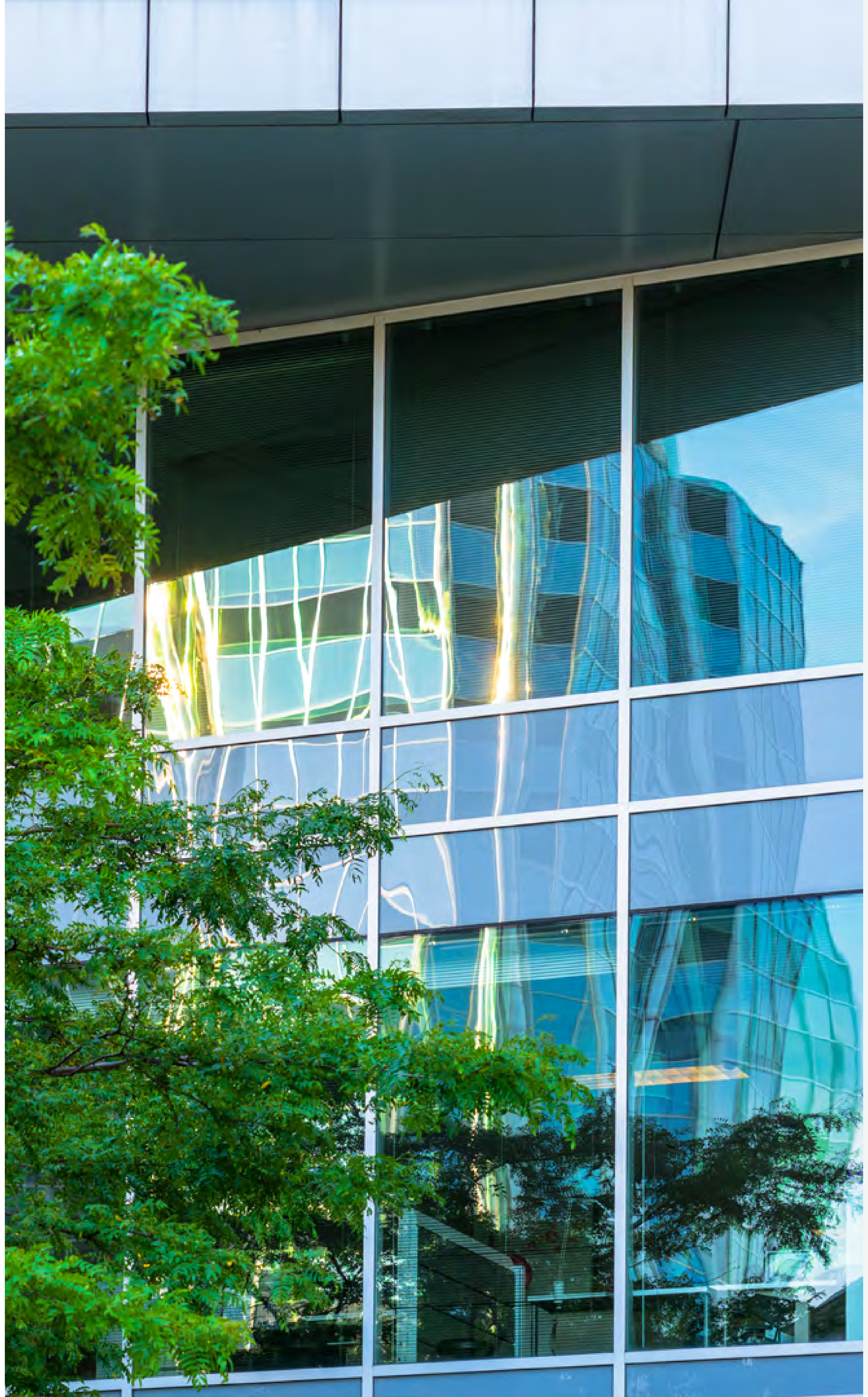
It has been designed to govern the issuance, distribution and, where relevant, the publication of ESG ratings without intending to regulate their use. However, the Regulation is poised to present a major shakeup for this previously unregulated industry and will result in a significant change to the landscape of how ESG rating providers operate within the EU.

What are ESG ratings and what are they used for?

ESG ratings assess the impact of environmental, social and governance factors on a company and provide information about the sustainability performance of a company or a financial instrument, by assessing its exposure to sustainability risks and/or its impact on people and the environment. The Regulation clarifies that separate E, S and G ratings should be provided rather than a single ESG metric that aggregates E, S and G factors. However, if ESG rating providers decide to provide aggregated ratings, then they must disclose the rate and weight granted to each E, S and G component.

ESG ratings have become increasingly important for market participants, particularly amongst credit institutions, investment firms, insurance undertakings, and reinsurance undertakings, who use ESG ratings to inform their decisions on ESG investment strategies and as part of their risk management processes.

With the introduction of several EU regulatory disclosure regimes, such as the Sustainable Finance Disclosure Regulation (**SFDR**), Corporate Sustainability Reporting Directive (**CSRD**) and the Taxonomy Regulation, ESG ratings can be used as a source of information to assist with the disclosure requirements under these regimes, building on and complementing the other sources of data being used.

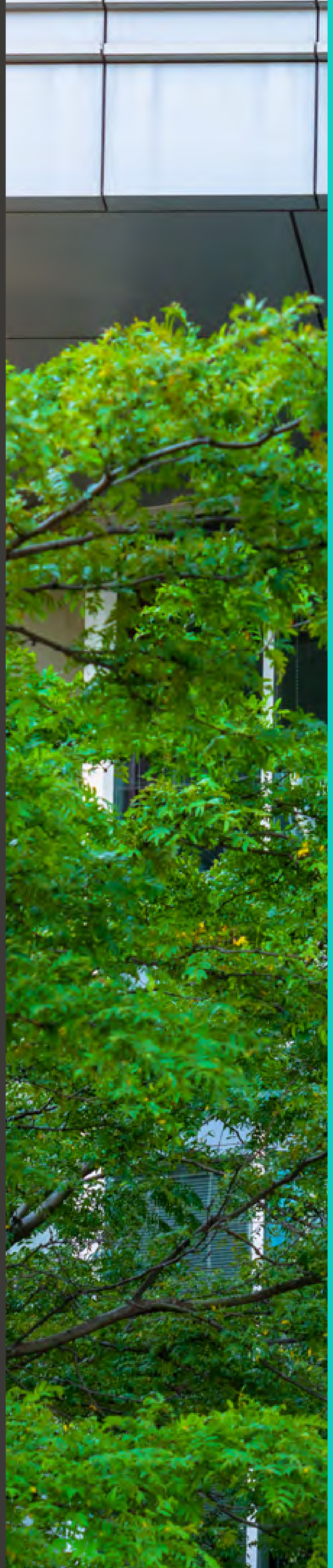


The Regulation provides the first legislative EU definition of an ESG rating, defining it as: *"an opinion, a score or a combination of both, regarding a rated item's profile or characteristics with regard to environmental, social and human rights, or governance factors or exposure to risks or the impact on environmental, social and human rights, or governance factors, that are based on both an established methodology and a defined ranking system of rating categories, irrespective of whether such ESG rating is explicitly labelled as 'ESG rating', 'ESG opinion' or 'ESG score".*

ESG opinion means *"an ESG assessment that is based on a rules-based methodology and defined ranking system of rating categories, involving directly a rating analyst in the rating process or systems process".*

ESG score means *"an ESG measure derived from data, using a rule-based methodology, and based only on a pre-established statistical or algorithmic system or model, without any additional substantial analytical input from an analyst".*

The Regulation also provides a definition for ESG rating providers, which means *"a legal person whose occupation includes the issuance and publication or distribution of ESG ratings on a professional basis".*



Scope

The Regulation applies to ESG ratings issued by ESG rating providers operating in the EU that are disclosed publicly or that are distributed to regulated financial undertakings, undertakings that fall under the Accounting or Transparency Directives, EU institutions, bodies, offices and agencies or Member State public authorities.

Third country ESG rating providers will only be subject to the Regulation in the circumstances where they actively distribute ESG ratings into the EU.

Despite the broad reach of the Regulation, several types of ESG ratings are excluded from the scope. These include, among others:

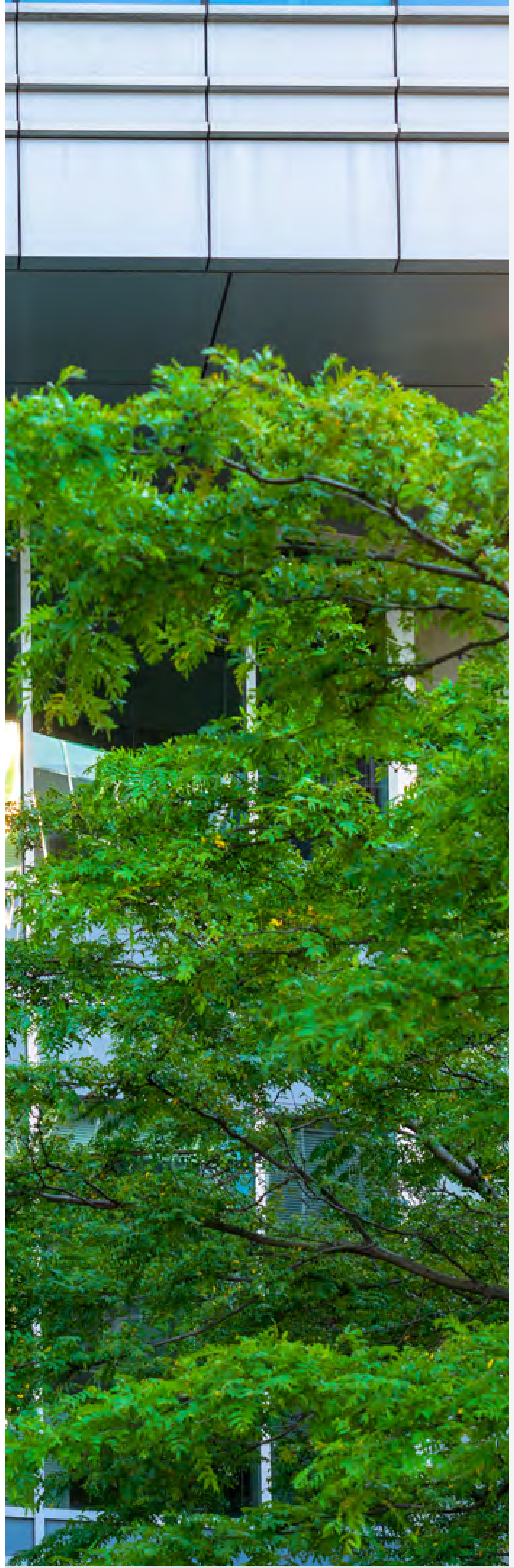
- private ESG ratings
- ESG labelling activities
- ESG ratings used exclusively for internal purposes
- ESG ratings incorporated in a product or service, where such products or services are already regulated under Union Law and are disclosed to a third party
- mandatory disclosures pursuant to SFDR and the Taxonomy Regulation, see Figure 1.

Despite the broad reach of the Regulation these exemptions will be welcomed by ESG rating providers. In particular, the exemption for ESG ratings incorporated in products and services that are already subject to regulatory, governance and disclosure requirements will prevent additional burdens being placed on ESG rating providers that are already subject to legal requirements.

The second part of this series provides an overview of the organisational processes and governance requirements being introduced by the Regulation, focusing on the conflicts of interest and disclosure requirements as well as setting out some practical considerations for ESG rating providers.

Figure 1: *SFDR and the Taxonomy Regulation disclosure obligations*

SFDR and the Taxonomy Regulation disclosure obligations	
SFDR Article 6	▪ requires Financial Market Participants (**FMPs**) to disclose whether sustainability risks are incorporated into their investment choices and the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.
SFDR Article 8	▪ requires FMPs whose financial product promote environmental or social characteristics to disclose information on how those characteristics are met.
SFDR Article 9	▪ requires FMPs whose financial products have a distinct sustainability objective to disclose an explanation on how that objective is to be attained.
SFDR Article 10	▪ requires FMPs to publish and maintain summary information on a public website regarding financial products which promote environmental or social characteristics (Article 8), or which have sustainable investment as their objective (Article 9).
SFDR Article 13	▪ requires FMPs to ensure that their marketing communications do not contradict any information disclosed pursuant to SFDR.
Taxonomy Regulation Article 5	▪ requires financial product falling within Article 9 of the SFDR to disclose certain prescribed information on the taxonomy-alignment of their products.
Taxonomy Regulation Article 6	▪ requires financial products falling within Article 8 of the SFDR to disclose a prescribed statement that “the “do no significant harm” principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities”.
Taxonomy Regulation Article 8	▪ includes a disclosure obligation which requires in-scope entities to include information on how and to what extent their activities are associated with taxonomy-aligned economic activities in their non-financial statements or consolidated non-financial statements.



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